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# TAX REFORM PROPOSALS—III

## HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JUNE 13, 1985

(National Business Leaders)

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# CONTENTS

## PUBLIC WITNESSES

| | Page |
|---|---|
| Berry, William W., chairman and chief executive officer, Dominion Resources, Inc | 98 |
| Bethlehem Steel Corp., Donald H. Trautlien, chairman and chief executive officer | 28 |
| Bryan, John H., Jr., chairman, Grocery Manufacturers of America, Inc | 16 |
| Dart & Kraft, Inc., John M. Richman, chairman and chief executive officer | 86 |
| Dominion Resources, Inc., William W. Berry, chairman and chief executive officer | 98 |
| General Foods Corp., Philip L. Smith, president and chief operating officer | 107 |
| General Motors Corp., Roger B. Smith, chairman and chief executive officer | 2 |
| Procter & Gamble Co., John G. Smale, president and chief executive officer | 40 |
| Richman, John M., chairman and chief executive officer, Dart & Kraft, Inc | 86 |
| Smale, John G., president and chief executive officer, the Procter & Gamble Co | 40 |
| Smith, Philip L., president and chief operating officer, General Foods Corp | 107 |
| Smith, Roger B., chairman and chief executive officer, General Motors Corp | 2 |
| Trautlien, Donald H., chairman and chief executive officer, Bethlehem Steel Corp | 28 |

## ADDITIONAL INFORMATION

| | |
|---|---|
| Committee press release | 1 |
| Prepared statement of Roger B. Smith | 5 |
| Grocery Manufacturers of America, Inc., John H. Bryan, Jr., chairman | 18 |
| Prepared statement of John H. Bryan, Jr | 18 |
| Prepared statement of Donald H. Trautlien | 30 |
| Prepared statement of John G. Smale | 41 |
| Prepared statement of John M. Richman | 89 |
| Prepared statement of William W. Berry | 99 |
| Prepared statement of Philip L. Smith | 109 |

## COMMUNICATIONS

| | |
|---|---|
| J.C. Penney, Inc | 126 |
| R.J. Reynolds Industries, Inc | 138 |

# TAX REFORM PROPOSALS—III

THURSDAY, JUNE 13, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Heinz, Wallop, Symms, Grassley, Long, Bentsen, Moynihan, Baucus, and Bradley.

[The press release announcing the hearing follows:]

[Press release No. 85-033, May 30, 1985]

CHAIRMAN PACKWOOD ANNOUNCES FINANCE TAX REFORM HEARINGS

Senator Bob Packwood (R-Oregon), Chairman of the Committee on Finance, travelling in Oregon, today announced that the Committee will begin hearings in early June on President Reagan's tax reform proposal.

"The Committee's work on the President's proposal will begin with Treasury Secretary Baker's testimony on June 11th," said the chairman of the Senate tax-writing committee, "and will involve upwards of 30 days of hearings—3 or 4 days each week the Senate is in session during the months of June, July and September."

Chairman Packwood announced the first five days of hearings, as follows:

Secretary of the Treasury James A. Baker III will present the President's tax plan to the Committee on Tuesday, June 11, 1985.

Internal Revenue Service Commissioner Roscoe Egger will appear before the Committee to testify on Wednesday, June 12, 1985.

On Thursday, June 13, 1985, the Committee will receive testimony from invited national business leaders.

On Monday, June 17th, public witnesses will testify on the impact of the tax reform proposal on people below the poverty line.

On Tuesday, June 18, 1985, witnesses invited by the Committee will discuss the general issue of whether corporations ought to pay a higher percentage of the income tax burden.

All hearings will begin at 9:30 a.m. and will be held in Room SD-215 of the Dirksen Senate Office Building.

The CHAIRMAN. The committee will come to order, please. We have today a most distinguished collection of witnesses from a broad spectrum of American industry, here testifying basically in support of the general thrust of the bill. I am sure we will have some questions to you about some parts of your testimony and some parts of the bill, and some of you may have some dissent from some portions of it, but I do appreciate the fact that you are willing to be courageous enough to come forward and say in general, by and large we think the bill is a pretty good bill. And I cannot tell you how much I appreciate your taking the time this morning. Senator Long.

Senator LONG. Mr. Chairman, I will try to cooperate by not making an opening statement and I am hoping others will do the same. I will withhold on this occasion.

The CHAIRMAN. Pat.

Senator MOYNIHAN. What do I get if I don't make an opening statement? [Laughter.]

The CHAIRMAN. A phase-out of the—no, I won't say that: Our first panel today consists of Roger Smith, the chairman and CEO of General Motors; John H. Bryan, Jr., the chairman of the Grocery Manufacturers of America and chairman and chief executive officer of Sara Lee Corp., Donald Trautlein, chairman and CEO of Bethlehem Steel Corp., and John Smale, the president and CEO of Procter & Gamble. And unless you gentlemen have any objections, we will take you in the order that you appear on the witness list. Is that all right? Mr. Smith.

## STATEMENT OF ROGER B. SMITH, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GENERAL MOTORS CORP., DETROIT, MI

Mr. SMITH. Thank you very much. I am Roger B. Smith, chairman of General Motors Corp., and I am very pleased to have this opportunity to offer GM's views this morning.

General Motors believes that the time for comprehensive tax reform has come. We believe a sounder tax system will contribute to a healthier economic environment in which everyone can prosper.

This morning I would like to discuss the five fundamental goals for tax reform that GM has identified. These goals are: To raise adequate revenue, to treat taxpayers fairly, to promote economic efficiency by making the tax system more neutral in its effect on economic decisions, to maintain international competitiveness, and to make the Tax Code as simple as possible. Now, of course, the primary goal of the tax system must be to raise the revenue necessary to support Government operations. The tax system's burden on economic activity will be minimized if tax rates are set as low as possible consistent with meeting revenue needs. By broadening the tax base, marginal tax rates can be reduced without reducing overall revenues.

The second and third goals, fairness and neutrality, require that similarly situated taxpayers bear similar shares of the tax burden and that the Tax Code not favor one taxpayer or industry over another, or one form of investment or consumption over another. A broader tax base—created by eliminating special tax deductions, credits, and exemptions—would help assure that the tax system would not favor certain classes of taxpayers. On the goal of neutrality, our free enterprise system is based on the concept that the marketplace generally will direct resources to their highest and best uses. Because the current tax system favors certain types of transactions, resources are directed toward these uses—even though they might be less productive than other less favored uses. Investments should be made on the basis of economic efficiencies, not because of tax considerations.

The fourth goal of tax reform should be to foster international competitiveness. This could be accomplished by lower tax rates and a more neutral tax system which neither favors nor hinders multinational activity. Our current system of taxation of foreign operations strikes a delicate balance, and care should be taken to assure that tax reform does not upset this balance.

The final goal of tax reform should be simplification of the system itself. Both taxpayer compliance and Internal Revenue Service administration can be aided by a tax system that is as clear and understandable as possible. Tax simplification will also help reduce the perception of unfairness that taxpayers have when they see others benefitting from tax breaks that they can't claim.

Now, with these goals in mind, I have some very brief comments on the President's tax reform proposal. The most significant proposal in the President's plan is the reduction of tax rates—to a top rate of 33 percent for corporations and 35 percent for individuals. At the same time, the tax base would be expanded by elimination of numerous tax preferences, to produce a proposal that is essentially revenue neutral. As a participant in the capital intensive automobile industry, GM will certainly be impacted by such items as the elimination of the investment tax credit and scaling back of depreciation deductions. Yet we believe the benefits of a healthier economy resulting from rate reduction and increased fairness can outweigh these costs. The President's proposal moves toward greater neutrality in financing decisions by providing a deduction for 10 percent of corporate dividends. Although we would have preferred to see a greater percentage of dividends deducted, implementation of the concept itself is an important positive factor.

Now, a late starter, added to the proposal shortly before its release, is the so-called recapture of a portion of accelerated depreciation deductions taken since 1980. Now, this novel approach has not received the close scrutiny other provisions of the original Treasury proposal received. This provision needs careful review, not only in terms of the concept itself, which is unprecedented, but also in the way it would be applied. As proposed, it would disproportionately affect certain companies that made investments through the difficult years since 1980. This is so because it focuses solely on depreciation and not on other areas similarly affected by rate reductions. Also, the method of calculation of the so-called recapture is arbitrary and results in an excessive tax burden on capital investment.

Another question that needs to be answered is if, in the future, tax rates are raised, would corporations be permitted to make adjustments for the depreciation writeoffs taken at lower rates which were in effect when those commitments were made? In sum, as it has been proposed, the recapture provision lacks the basic elements of fairness and should not be adopted. Another point of concern relates to certain of the international tax changes. We believe it is important that these provisions not detract from the overall improvement in our Nation's international competitive position which can result from tax reform. We do believe the current overall method of averaging of overseas income and taxes and the current sourcing of income rules are generally preferable to the proposed approach, and we believe that any perceived abuses can be addressed directly.

In summary, we find merit in the President's tax reform proposal, and with the exception of the so-called recapture provision, believe it is sound from a tax policy standpoint. It goes a long way toward achieving what we believe should be the major goals of tax reform. The opportunity for comprehensive tax reform comes infrequently, and we believe it is here now. Reform can be accomplished with a concerted bipartisan effort, and I can assure you that General Motors will give its support to that effort. Thank you very much, Senator.

The CHAIRMAN. Thank you, Mr. Smith. Mr. Bryan.

[The prepared written statement of Mr. Smith follows:]

Statement of

General Motors Corporation

to the

Finance Committee

of the

United States Senate

on

Reform of the Income Tax System

Presented by
Roger B. Smith
Chairman and Chief Executive Officer
June 13, 1985
Washington, D.C.

I am Roger B. Smith, Chairman General Motors Corporation. I am pleased to have this opportunity to offer GM's views on the need for reform of this nation's income tax system.

General Motors is the world's largest automobile manufacturer, employing about 800,000 people worldwide. We have facilities in 26 states, Canada and 37 other foreign countries. In 1984 General Motors sold 8.3 million cars and trucks, had revenues of $83.9 billion, and made capital investments totaling $6 billion. But our business extends beyond the production and sale of motor vehicles. We also produce locomotives, turbine engines, and aircraft navigational systems. Over the past several years the auto industry has become one of high technology, and GM has become the world's leading manufacturer of control computers. Our recent acquisition of Electronic Data Systems and proposed acquisition of Hughes Aircraft have accelerated our transition into a true high-tech company. The wide scope of our operations requires that we take a broad view of tax reform and its benefits.

General Motors believes the time for comprehensive tax reform has come. In recent years, most of the changes in the tax system have been piecemeal and have added complexity to the tax system. During this same period there has been rising discontent with the tax system itself. Many taxpayers believe "the other guy" receives benefits from tax breaks that they themselves cannot utilize. A recent poll done for the Internal Revenue Service reportedly found a large majority of Americans who believe the tax system is not fair to the ordinary working person. The complexity of the system has forced more and more people to resort to professional preparation of their tax returns. In response, a variety of tax reform proposals has been proposed, some of them very similar in their basic approaches. In short, there is a growing recognition of the need for tax reform.

General Motors' involvement in the process of tax reform stems from the guiding principles in our corporate mission statement, one of which states: "We will participate in all societies in which we do business as a responsible and ethical citizen, dedicated to continuing social and economic progress." We believe that reform of the tax system is essential to social and economic progress. From this perspective, tax reform is the "right" thing to do.

GM's reasons for supporting tax reform are specific as well as general. We believe a better tax system will contribute to a stronger, more efficient and productive economy. A stronger economy translates into more car sales. So we also have a direct and tangible interest in achieving meaningful tax reform.

As you begin the process of determining how best to change the current tax laws, it is important to establish the appropriate role of the tax system in the nation's overall economic and social structure. We believe that reform should pursue five fundamental goals: to raise adequate revenue to fund government activity; to treat taxpayers fairly, taking account of relative economic circumstances; to promote economic efficiency by making the tax system more neutral in its effects on economic decisions; to maintain international competitiveness; and to make the tax code as simple as possible.

Obviously, the primary goal of the tax system must be to raise the revenue necessary to support government operations. Setting the appropriate level for government operations is a critical but separate issue, but clearly, tax reform will come more easily at a time when spending is being cut and the pressure for revenue increases is not growing.

Low tax rates will reduce the impact of tax considerations on economic decisions. Low rates will also reduce the temptation of non-compliance with the tax rules. By broadening the tax base, marginal tax rates can be reduced even in a revenue-neutral tax reform plan.

The system should be as fair and neutral as possible, so as not to distort the allocation of resources within the economy. Although fairness and neutrality are two separate goals, they are in many ways interrelated.

Fairness and neutrality both require that similarly situated taxpayers bear similar shares of the tax burden. They require that the tax code not favor one taxpayer or industry over another, or one form of investment or consumption over another. A broader tax base would help assure that the tax system does not favor certain classes of taxpayers. Special tax deductions, credits, and exemptions -- while they have often been used to promote social or economic goals -- run counter to the principles of fairness and neutrality if not used with caution. If incentives are deemed necessary to promote social and economic goals, we believe, as a general rule, these goals could be more effectively promoted through means other than tax incentives. One alternative, that of direct subsidies, would make the public costs of such incentives more explicit.

In addition, fairness requires that different forms of income all be evenly taxed once, but only once. By broadening the definition of "taxable income" to include many types of income and compensation that are not currently subject to taxation, we can come closer to taxing all income once. And reducing the double taxation of corporate dividends, by allowing corporations to at least partially deduct dividend payments to shareholders, will address the most prominent example of the same income being taxed more than once. If the tax system adheres to this principle of taxing a broad range of income once and only once, it can raise adequate revenue even at low rates of taxation.

Finally, it is not enough that the system be fair. Taxpayers must also perceive it as being fair. Several polls have found the American public believes the Federal income tax to be the least fair of all taxes -- less fair than state income and sales taxes and less fair than local property taxes. This is especially troubling because our income tax system relies so heavily on voluntary compliance. Taxpayers must perceive the system as being fair, if they are expected to assume their share of the burden it imposes.

It is well recognized that there is nothing legally wrong with minimizing one's taxes. However, a system that allows too many opportunities for tax minimization, to the extent that substantial tax burdens may be eliminated entirely, fosters the perception of unfairness. This perception must be addressed to restore confidence in the system.

A few additional points on the goal of neutrality are in order. First, our economic system is based on the general concept -- and there are exceptions involving especially public health and welfare -- that the marketplace will direct resources to their highest and best uses. A neutral tax system is one that will avoid handcuffing the marketplace. Currently, the tax consequences of a transaction are a key element that must be factored into business decisions. Because the tax system favors certain types of transactions, resources are directed to these uses, even though they might not be as productive as other types of transactions that are not similarly favored by the tax system. We are of the view that tax considerations should be removed from business decisions, or at least minimized, so the market will be able to function more efficiently to direct resources to their most productive uses.

One example of how tax considerations distort business decisions is in the area of corporate financing. The cost of debt financing -- interest expense -- is fully deductible for the corporation. On the other hand, dividend payments on corporate equity are not deductible. This different treatment for the two types of financing tends to encourage the use of debt financing at the expense of equity, resulting in increased corporate leverage. Increased leverage leads to more built-in corporate costs, and a reduced ability to weather fluctuations in business conditions. Allowing a full deduction for corporate dividend payments would remove the bias in favor of debt financing and promote the strengthening of corporate balance sheets through the issuance of additional equity securities.

It has been suggested that investment incentives are needed if this country is to remain competitive on world markets. We believe scaling down existing biases in the tax system, combined with rate reduction, would be an effective incentive for useful, productive investments. This might not increase the gross amount of investment, but would help assure that new investment would contribute to the nation's economic efficiency, productivity, and ability to compete internationally. It would increase the quality of investments made by reducing the amount of resources directed into non-productive tax shelters.

The fourth goal of tax reform should be to foster international competitiveness by recognizing the basic nature of integrated multinational enterprises, and not favoring or hindering multinational activity. Our analysis indicates that the primary cause of the trade deficit is not the U.S. tax system, but rather the strong dollar (which has been caused, in large part, by continuing Federal budget deficits) coupled with the increasing competitiveness of foreign industries. This leads us to the conclusion that public policymakers can make their greatest contribution toward resolving the nation's trade problems, not by making tax changes, but by reducing budget deficits and pursuing negotiations with our international trading partners.

Just as the tax system should not favor multinational activity, neither should it hinder such activity. Provision should be made to assure that income resulting from overseas operations is not subjected to excessive levels of taxation, or overly restrictive tax rules.

The final goal of tax reform should be simplification of the system. This is desirable both for purposes of compliance and administration. Voluntary compliance is made easier by a tax system that is as clear as possible and can be understood by taxpayers themselves. Simplicity of the tax code will also ease the Internal Revenue Service's administrative burden. It could even assist in IRS efforts to move toward a "paperless" filing system toward the end of the decade. Finally, tax simplification will help reduce the perception of unfairness that can be created when taxpayers view others as benefiting from tax breaks not available to themselves.

With these goals in mind, I have some brief comments on the Administration's latest effort to reduce the concept of the ideal tax system to a specific proposal for reform. As you may know, General Motors was an early supporter of the Treasury's effort to develop a logical, workable, comprehensive tax reform plan. We believe the President's proposal is an important second step in this process.

The most significant accomplishment of the President's proposal is its reduction of tax rates. The top corporate tax rate is reduced to 33% and the top individual rate is brought down to 35%. This reduction in rates in a proposal that remains essentially revenue neutral is made possible by the adoption of an expanded tax base. Numerous tax preferences have been eliminated. As a participant in the capital intensive automobile industry, GM will certainly be impacted by such items as elimination of the investment tax credit and scaling back of depreciation deductions. Yet we believe the benefits of a healthier economy resulting from rate reduction and increased fairness can outweigh these costs.

The broadening of the tax base and elimination of many tax credits and other preferences also helps to make the tax system more fair -- for both individuals and corporations. If the plan is adopted, confidence in the income tax system should improve as taxpayers recognize that they are no longer being treated differently than their neighbors, and that profitable corporations are bearing their fair share of the tax burden.

The President's proposal moves toward providing greater neutrality in financing decisions by providing a deduction for 10% of corporate dividends. Although we believe that higher levels of dividend deductibility are fully justified and should be seriously considered by Congress, acceptance of the concept of dividend deductibility would be an important positive contribution to our tax system. This will reduce the system's current bias in favor of debt financing.

The proposal also makes capital cost recovery more neutral than the current system, and should reduce the impact of tax considerations on investment decisions.

Finally, the President's proposal makes advances in simplifying the tax system, particularly for individuals. While some provisions will complicate the calculation of tax liabilities -- the indexation of asset costs for depreciation purposes is one example -- this type of change is mostly limited to the area of business taxes. Here, simplicity is less essential since businesses generally have access to the expertise necessary to cope with more complex tax provisions. In the individual area, the elimination of many deductions and credits, coupled with a reduction in the number of tax brackets and lower tax rates, should make the annual chore of filing an income tax return less confusing and frustrating.

A "late starter," added to the proposal shortly before its release, is the so-called "recapture" of a portion of accelerated depreciation deductions taken since 1980. This novel approach has not received the close scrutiny other provisions of the original Treasury proposal received.

This provision needs careful review not only in terms of the concept itself, which is unprecedented, but also in the way it would be applied.

As proposed, it would disproportionally affect certain companies that made investments through the difficult years since 1980. This is so because it focuses solely on depreciation and not on other areas similarly affected by rate reductions. Also, the method of calculation of the so-called recapture is arbitrary and results in an excessive tax burden on capital investment.

In sum, as it has been proposed, it lacks the basic elements of fairness and should not be adopted.

The second point relates to certain of the international tax changes. We believe it is important that these provisions do not detract from the overall improvement in our nation's international competitive position which can result from implementing comprehensive tax reform We believe the current "overall" method of averaging overseas income and taxes and the current sourcing of income rules are generally preferable to the proposed approach, and believe that any perceived abuses can be addressed directly.

In summary, we find much merit in the President's tax reform proposal and believe it is sound from a tax policy standpoint. It goes a long way toward achieving what we believe should be the major goals of tax reform. We believe it is important to emphasize the broad social and economic benefits that can be achieved through fundamental tax reform.

The time is ripe for tax reform, and we believe it can be accomplished with a concerted bi-partisan effort. I can assure you that General Motors will give its support to that effort. Thank you.

## STATEMENT OF JOHN H. BRYAN, JR., CHAIRMAN, GROCERY MANUFACTURERS OF AMERICA, INC., AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SARA LEE CORP., CHICAGO, IL

Mr. BRYAN. Thank you. My name is John Bryan, Jr. I am chairman of the Grocery Manufacturers of America, the primary trade association of the food industry, and chairman and chief executive officer of the Sara Lee Corp.

In its 77-year history, GMA has rarely taken positions on economic policy, but we are part of an industry which represents 15 percent of our gross national product and nearly 13 million employees. Sara Lee Corp. has no Washington lobbying office, but we are a company with $8 billion in sales and approximately 100,000 employees. The manufacturers we represent support fundamental tax reform, which would permit corporate rate reduction and the deductibility of dividends. We are unequivocal in our support and offer no qualifications to this position.

Let me relate the reasons. First, the self-serving one. GMA members are among the highest effective tax rate payers in industry. Food processors pay an effective rate of nearly 30 percent, while all industry averages about 16 percent. Also, our industry is a relatively high payer of dividend. But my primary motivation for this testimony flows from a strong personal conviction that our present Tax Code misserves our Nation. I do not think it should be fashioned by responding to the appeals of special business interests. Nor should there be a de facto industrial policy under cover of the Tax Code. Why? It is dramatically evident that tax preferences for some create higher tax rates for all of us. GMA believes that the proposed lower tax rates offer the prospect of unparallelled growth for our country.

Second, our current tax system grossly misdirects the financial and human resources of our country. How can it possibly be in our country's best interest for us to be directing our most talented people to spend their energies and their financial resources on schemes to avoid paying taxes? The tax shelter is an extraordinarily bad idea, and it is not just individuals who are pursuing tax shelters. Large corporations across America are setting up financing subsidiaries designed primarily to shelter their taxes. I am confident that, without changing the present Tax Code, we shall eventually wipe out any appreciable tax revenue from corporate America.

Third, I think it is highly questionable that tax preferences achieve their sought-after purposes. If our objective is to create jobs, why do we allocate most tax breaks to nongrowing, low labor-intensive business, as we drain resources from the growing labor-intensive companies of tomorrow? Is that an intelligent growth strategy? The time, I think, has come to put the Tax Code off limits to special business interests.

Over the summer, you will hear many witnesses with contrary views. There are those who will say our industry is failing—save us. And I remind you that an industry losing money does not pay taxes, and industries do not fail because they pay taxes.

There are those who will say tax breaks are unnecessary—or necessary because our trade policies subject them to unfair competition. If that is true, then it is the trade policy—it is not the Tax Code—which should be changed.

There are those who will say that the security of our Nation relies on their particular tax breaks. The Tax Code is not the proper place upon which our national defense should rely.

There are those who will say that unemployment will rise and our economy will be in trouble with the elimination of ITC and ACRS. I remind you that the primary recipients of those hundreds of billions of dollars of tax breaks have not created jobs over recent years. Most new jobs have been created by industries who did not get tax breaks.

And there are those who will say that we are becoming a Nation of hamburger stands. They will raise the fear of a declining industrial America. Our country is moving from an age of industry into an age of technology and service. Earlier in this century, we made the transition from an agricultural-based economy to an industrial one. Millions of people left the farms and moved into industry, and yet agriculture remains one of our great successes. The evolution taking place today will not destroy the industrial base of America, and I do not believe the tax laws can or should be used to alter this progression of our Nation.

We grocery manufacturers are here today not to ask for any special favor. We simply ask for the now well-known level playing field. We ask that you will seize this truly historic opportunity to reform the governance of America. We ask that you craft a Tax Code that is simple and fair and one that says to the business community: Make your business decisions in a truly economic manner and forget about tax consequences, for we have genuine faith that our economic system will serve our country better under the tax reform proposal for which we have today expressed our support. Thank you.

The CHAIRMAN. Thank you very much. Mr. Trautlein.

[The prepared written statement of Mr. Bryan follows:]

Statement of John H. Bryan, Jr.
Before the
Committee on Finance
United States Senate
June 13, 1985

My name is John H. Bryan, Jr. I appear before the Committee today as Chairman of the Board of the Grocery Manufacturers of America, Inc. (GMA), a trade association of manufacturers and processors of food and nonfood products sold throughout the United States and overseas. I also appear before you as Chairman and Chief Executive Officer of the Sara Lee Corporation.

GMA's member companies employ over 2.5 million people and have total annual sales of more than $250 billion. The food industry, of which GMA is an integral part, represents 15% of our GNP, with 1984 revenues of over $500 billion and nearly 13 million employees. Sara Lee Corporation is a diversified food products manufacturer and processor with more than 100,000 employees and annual sales of over $8 billion.

Mr. Chairman, GMA is a seventy-seven year old trade association. It is an organization which has rarely taken positions on broad economic policy. Sara Lee Corporation does not have a Washington lobbying office. In over ten years as the CEO of Sara Lee, I have never testified before a Congressional panel. We are indeed a new face.

Let me state our position. The manufacturers we represent support tax reform and a fundamental overhaul of our federal tax code. We are unequivocal in our support and offer no qualifications to it. The focus of our support rests on corporate rate reduction and the deductibility of dividends.

Let me relate the reasons for our position. First, the self-serving ones. GMA's member companies -- soap and cosmetic manufacturers, pharmaceuticals, tobacco companies and food processors -- are among the highest effective rate taxpayers in industry, according to the most recent study by the Joint Tax Committee. Food processors, which are the heart of our organization, paid an effective tax rate of 29.5% over the last three years while all industry averaged 16.7%.

Also, GMA member companies are relatively high dividend payers, and would derive benefits from the deduction of a portion of dividends paid out to shareholders. We genuinely are concerned about the disparity in the treatment between equity investment and debt financing.

These are important reasons for our position. But, in addition, let me explain my primary motivation for this testimony. It is that I have a very strong conviction that our present tax code disserves our nation. I do not think that it should be fashioned by responding to the appeals of special business interests. And I do not think that there should exist a de facto industrial policy which, under the cover of the tax code, chooses special industries for support.

I offer several reasons for these convictions. First, it is dramatically evident that tax preferences for some create higher tax rates for all of us. High rates do stifle economic growth. GMA believes that the proposed lower tax rates offer the prospect of unparalleled growth for our country.

Secondly, our current tax system grossly misdirects the financial and human resources of our country. I would like to tell you a story which has had a profound impact on my point of view in this regard.

Seven years ago, the Sara Lee Corporation acquired a relatively small, but growing, frozen food company. It had been founded by a talented, young, second generation entrepreneur. The founder took Sara Lee Corporation stock in exchange for his company. And he agreed to a five-year contract to continue running the company.

Two years later, with this new acquisition performing quite well, he came to me to offer what he called the good news and the bad news. The good news was that during the previous year, with dividend and salary income of about $1 million, he had paid a federal income tax of $4,000. The bad news was that he had to ask us to let him out of his contract. He had become so involved in all his tax shelters that he had to quit.

I have had a significant disdain for tax shelters ever since.

How can it possibly be in our country's best interest for us to be directing our most talented people to spend their energies and their financial resources on schemes to avoid paying taxes?

And it is not just individuals who pursue tax shelters. Large corporations across America are setting up financing subsidiaries designed primarily to shelter their taxes.

I am confident that without changing our present tax code, and with increasing corporate tax management skills, we could eventually wipe out any appreciable tax revenue from corporate America.

Thirdly, I think it is highly questionable that tax preferences achieve their sought-after purposes. The presumed purpose of most tax preferences is to stimulate growth of the economy and create jobs.

Why then do we allocate most tax breaks to non-growing, low labor-intensive businesses? If our objective is to create jobs, how can it be an intelligent growth strategy to drain resources from growing, labor-intensive companies of tomorrow?

Another often stated purpose of tax preferences is to stimulate the productive output of an industry. This artificial tampering with the marketplace so often causes more damage than good to an industry in the long run.

The irrationalities of our tax code do occur, I think, in large measure because of our political approach to creating our tax code. Industrial policy fashioned by responding to those who make best use of political skills is not good practice.

The time has come to put the tax code off limits to business interests.

Finally, and unfortunately, the opportunity for abuse is directly related to the degree of complication and the number of preferences allowed in the tax code.

Abuse, as I see it, is tax avoidance -- realized without the purpose of the tax preference being served, or excessive tax avoidance in relation to the benefit received.

The abuses are many. You have heard them before. Tax reform can end most of them.

I have related some of the reasons which persuade me that tax reform must take place. I know, however, that over the summer you will hear many witnesses with contrary views. Let me offer some responses to the often heard appeals of special interests.

There are those who will say "our industry is failing -- save us." I remind you that an industry losing money does not pay taxes. And industries do not fail because they pay taxes.

Companies and industries fail because of problems within the structure of their marketplace, their products, or their management. The degree of the impact of each is usually debatable, but tax breaks are not an effective way to save a failing industry.

There are those who will say that our trade laws, or the lack of their enforcement, subject them to "unfair competition," so they ask for a tax break.

If there is a genuine wrong perpetrated on an industry by our trade policy, we can and should use trade regulation to correct that wrong. But it grossly compounds that possible wrong to use tax money of one industry for reducing the cost of the products of companies who have problems, which may or may not be related to "unfair competition."

And there are those who will say that the security of our nation relies on their particular tax breaks.

Surely there can be no end to the commodities and businesses which are vital to our national defense, including perhaps even food products. But, obviously, the tax code is not an adequate or a proper place to give the responsibility for our national defense.

There are those who will say that unemployment will rise and our economy will be in trouble with the elimination of ITC and ACRS. I remind you that the primary recipients of those hundreds of billions of dollars of tax breaks have not created new jobs over recent years. Most new jobs have been created by industries who did not get tax breaks.

Low tax rates will create new jobs. I am reasonably sure that no country's economy has ever been strangled by low tax rates.

There are those will say that we are becoming a nation of hamburger stands. They will raise the fear of a declining industrial America. It is true, as futurists have pointed out for a decade or so, that our country is moving from an age of industry into an age of technology and service. Earlier in this century, our country made the transition from an agricultural-based economy to an industrial one. Millions of people left the farm and moved into industry. Yet agriculture remains one of our great successes.

The evolution taking place today will not destroy the industrial base of America. And I do not believe that tax laws can, or should, be used to try to alter this progression of our nation.

There are those who will say, "we have built our businesses, developed products, and have employed people because of special tax breaks -- we simply followed the laws -- you are changing the rules -- that is unfair."

A constantly changing tax code _is_ a real burden to business. But surely we cannot freeze today's tax code. Let us reform it first, and then freeze it. Those affected businesses can, and quickly will, redirect themselves to operate along economic paths rather than tax-motivated ones.

You will hear these and more cries from various business interests as the proposed tax legislation is debated in the months ahead. But it is my judgment that fundamental tax reform is much more favored by the business community than is generally believed. It is not a natural instinct for business people to seek government subsidies. It is just that so many have been so conditioned over the past 40 years, and so much machinery is in place to "play the game."

As I often debate my point of view with business friends, they say, "John, you're right -- in principle you're right -- but you're naive. If I don't fight for my tax breaks, they'll give them to someone else."

Or they say, "If we eliminate business tax breaks, they'll just raise everybody's taxes so they can spend more money."

Perhaps I am naive, but these reasons for preserving our present state are not very persuasive to me.

Finally, I remind you that we grocery manufacturers are here today not to ask for any special favor. We ask simply for the now well-known level playing field. We ask that you seize this truly historic opportunity to reform the governance of America.

And we ask that you be determined to give our country a tax code that is simple and fair, and one that says to the business community -- now make your business decisions in a truly economic manner, with no regard for tax consequences.

For we have, as you must have, genuine faith that our free enterprise system will serve our country best. This, we believe, is reform.

Mr. Chairman, I, and the industry I represent, are here today to offer our support toward that goal.

I would be pleased to respond to any questions you may have.

Thank you.

## STATEMENT OF DONALD H. TRAUTLEIN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BETHLEHEM STEEL CORP., BETHLEHEM, PA

Mr. **Trautlein.** Mr. Chairman and members of the committee, my name is Donald H. Trautlein. I am chairman and chief executive officer of Bethlehem Steel. I welcome this opportunity to participate in the important debate on the fundamental issue of restructuring the Tax Code to achieve fairness, growth, and simplicity. You have Bethlehem's statement, and we will be happy to provide any additional information at a later time.

The American people want a fairer and simpler tax system with lower tax rates. We want tax policies which will preserve manufacturing jobs in America, policies which will create and sustain growth in order to expand not only the industrial base but also the entire economy. I am sure most of us support the objectives of President Reagan's proposal, if not all of its details.

We believe the President's proposal is a good starting point from which to continue the debate. We support and endorse the concepts and his efforts. The President's proposal should not have any direct immediate impact on Bethlehem Steel. Nearly $1 billion of net operating loss carryovers and a quarter of a billion dollars of investment tax credit carryovers assure that. We hope and are sure that the committee will be very sensitive to the need to provide adequate transition rules.

Our concern then is that the proposal and what emerges from the legislative process will not have a negative impact on the manufacturing sector in general, which is our principal customer base. Our judgment is that the President's proposal should not have such a negative impact. The reasons for this conclusion are set out in detail in our statement. Basically, however, we believe that the CCR system would be about as effective as ACRS.

Also, the tradeoff between the repeal of investment tax credit and the rate reduction appears reasonably equitable. We do not believe it should necessarily have a negative impact on the total industrial sector, or more specifically, the manufacturing sector.

Now, to be still more specific about the steel industry, in September 1984 the President announced a national policy for the domestic steel industry. While it focused primarily on trade matters, it nevertheless included other features which are considered necessary if the industry is to modernize and improve its competitiveness.

Essentially, the President committed to analyze all U.S. Government domestic tax, regulatory, and antitrust laws, and policies to determine if there were any which could hinder the ability of the steel industry to modernize. Following the President's decision, Congress enacted the Steel Import Stabilization Act. The Congress confirmed that the steel industry had a serious need to increase capital investments for modernization in order to increase its international competitiveness. The Congress further found that the ability of the steel industry to be internationally competitive is and has been impeded by the effects of the enormous Federal deficit and overvalued dollar and a serious trade deficit. Additionally, it found that there was serious injury caused by the trade practices of many foreign governments including direct subsidies and dumping.

Now, we would appreciate your consideration of some recommendations which are not in the President's proposal but which would be of significant benefit to Bethlehem and the majority of the steel industry. These would include realizing an immediate cash benefit from our extensive earned but unused investment tax credits and net operating loss carryovers. We hope you will give serious consideration to these recommendations, which would give us much of the cash we so desperately need to modernize and to enhance our international competitiveness. We are available to elaborate on these recommendations at any time. Enactment of these proposals would help us return to the position of being a taxpayer. That is a position that we would dearly love to occupy again. Thank you. [Laughter.]

The CHAIRMAN. Mr. Smale.

[The prepared written testimony of Mr. Trautlein follows:]

# STATEMENT OF

DONALD H. TRAUTLEIN
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
BETHLEHEM STEEL CORPORATION

BEFORE THE
SENATE FINANCE COMMITTEE
UNITED STATES SENATE
JUNE 13, 1985

Mr. Chairman and Members of the Committee, my name is Donald H. Trautlein. I am Chairman and Chief Executive Officer of Bethlehem Steel. I welcome this opportunity to participate in the important debate on the fundamental issue of restructuring the tax code to achieve fairness, growth and simplicity.

We believe that most people want the whole complicated patchwork system of taxes analyzed, reviewed, and restructured in its entirety and at one time, so that we'll have a fairer, simpler system with lower tax rates in order to better serve the American people. This is the principal thrust of the President's proposal and we endorse and support the concept. We believe that the President's proposal is a good starting point from which to continue the debate on tax policy and tax reform.

The lower individual tax rates and reduction in corporate taxes through ACRS which were enacted in 1981 have been a major factor in the sustained economic recovery which has benefited most sectors of the American economy. This recovery has been unmatched in other parts of the world. We believe that an extension of this tax policy, coupled with a fundamental restructuring of the tax code to achieve a greater measure of fairness and simplicity for individuals, is sound policy.

The deficit problem is not a function of revenue decline. Total budget receipts actually increased by nearly $150 billion annually from 1980 to 1984 - an increase of almost 29% while tax rate reductions of 25% were being put in place.. Rather, federal outlays in recent years rose much faster than receipts --- from $591 billion in 1980 to $852 billion in 1984 - a whopping 44% increase. In the aggregate for the four year period (1981-1984), spending exceeded revenues by $600 billion. It is absolutely imperative that spending be brought under control and that the deficit be reduced substantially. This is a serious matter and cannot be put aside in favor of a debate over tax restructuring.

Bethlehem is different from many corporations. We have been seriously injured by unfairly traded steel imports. As a result, the President instituted a comprehensive fair trade program for the domestic steel industry. The Congress reinforced this program when it enacted the Steel Import Stabilization Act. We should soon have the benefit of the President's comprehensive and enforceable program. As a result of our losses and our continued determination to modernize, we have accumulated nearly $1 billion of net operating loss carryovers, and $250 million of investment tax credit carryovers.

With these carryovers, Bethlehem has an opportunity for several years to have taxable income without being directly and immediately affected by many of the proposals. Our principal concern then is how the tax reform process will impact on the economy in general and on our customers in particular. Obviously, we don't want tax policy to further accelerate the movement of industrial sector manufacturers overseas. We do want tax policy to preserve manufacturing jobs in America, and create and sustain growth in order to expand not only the industrial base in America but the entire economy. During the next several weeks and months, numerous economic analyses will be published, focusing on how the proposals will impact on the economy. We have some thoughts to share with you at this time.

A thesis has been proposed that the President's proposal would severely impact on heavy basic industry. We believe that this may be an overstatement. The four principal capital formation items which would have an effect on corporations are

(1) the new Capital Cost Recovery System (CCRS) compared to the current ACRS concept,
(2) the repeal of the investment tax credit,
(3) the rate reduction, and
(4) the depreciation add-back provision.

Other provisions in the proposal which would raise corporate taxes in the aggregate --- accounting changes, changes in the taxation of financial institutions or foreign operations --- are not specifically associated with capital intensive industries.

## CCRS/ACRS

We believe that the capital formation incentives of the CCRS proposal are not significantly different from those contained in the current ACRS system and that the aggregate national investment and savings will not significantly change as a result of its adoption. The total depreciation deduction claimed on corporate income tax returns is about $200 billion. The Treasury estimates that the total amount of revenue to be raised in the next three years is about $2 billion which is relatively minor compared to the revenue impact of the total depreciation deductions. Consequently, it could reasonably be concluded, that, taken alone, the change would not have a negative impact on investment decisions for manufacturing companies. In fact, the Treasury's analysis even suggests that the CCRS proposal is generally somewhat more beneficial than ACRS when some inflation is taken into account.

## Investment Tax Credit/Rate Reduction Trade Off

What then about the contention that basic industries would be devastated by the loss of the investment tax credit? This loss would be a serious problem if it were not offset. However, the President's proposal provides for a general rate reduction in lieu of the investment tax credit which some view as a selective rate reduction, and the two must be considered together. In 1981, the last year for which statistics have been published, there were 2.8 million corporations which filed federal income tax returns. Of this number, 1.3 million, or less than half of the corporations, calculated a tentative investment tax credit, and only about 0.8 million actually used the investment tax credit to reduce tax liability. Therefore, only 28% of the 2.8 million corporations filing income tax returns and only 62% of the 1.3 million claiming a credit actually benefitted currently from the investment tax credit earned in the year. This analysis would suggest that perhaps the investment tax credit is not as widely used or as effective as is generally assumed.

The investment tax credit is heavily concentrated in relatively few companies. It is widely assumed that the manufacturing sector in general and particularly those relatively few large companies would be devastated by the loss of the investment tax credit. An analysis of corporation income tax return statistics for the latest year available (1981) raises some questions about that assumption when the general rate reduction is put into the equation. Details are contained in the attached appendix. The conclusion is that in the aggregate, major basic manufacturing industries would not be badly damaged as a result of the trade off between the reduction in corporate tax rates and the repeal of the investment tax credit. If this is true, then it would follow that the heavy basic industry sector of the economy, which is a principal source of steel product sales, should not be adversely affected by this exchange.

## Depreciation Add-back

One provision which is bound to create a great deal of controversy is the provision that would require a portion of depreciation deducted in prior years to be added back to taxable income during the next three years. This provision also graphically demonstrates the difficulties which will be encountered because of the substantial rate drop and the need to pay particular attention to the transition from the current system to the proposed system. Since the provision does not effectively apply to companies such as ours with large loss carryovers, we will not comment on whether or not the provision is appropriate.

We would point out though that if the theory is to be applied then it should be applied uniformly to all situations in events that occur in the time frame of the 46% rate turn around and impact on income earned in the time frame of the 33% rate.

Specifically, net operating loss carryovers have earned a numerical cash equivalent at a 46% rate and they should not be diminished in value because they would be offset in the future against regular income taxable at 33% or alternative minimum income taxable at 20%.

If it is correct, as has been reported, that the depreciation add-back provision was added solely in order to achieve revenue neutrality, then we suggest that another source of revenue be found. An alternative would be something along the lines of the Business Transfer Tax introduced by Senator Roth last month. Another possibility would be to phase in or phase out various other proposals to keep the revenues neutral.

As the deliberations on tax reform continue there are several provisions of importance to the steel industry which we hope will be considered. I believe you will find general agreement within the industry on the benefit of these legislative proposals.

## Policy of the Administration and Findings of Congress

In announcing his decision on the steel import problem last year the President stated that his Administration's national policy for the U.S. Steel industry included, among other things, the establishment of an interagency task force "to analyze all U.S. Government domestic tax, regulatory and antitrust laws and policies which could hinder the ability of the steel industry to modernize."

The Congress enacted the Steel Import Stabilization Act after the President's decision was announced. One of the findings of Congress in this legislation was that full and effective implementation of the President's national policy for the steel industry would substantially improve the economy and employment in both the steel and iron ore producing sectors.

Another of the findings of Congress was that "the steel industry has a serious need to modernize its plant and equipment in order to enhance its international competitiveness and needs increased capital investments to effect that modernization."

We believe our legislative proposals are consistent with both the objectives of the President's national policy for the steel industry and the findings of the Congress.

## Steel Industry Legislative Proposals

With imports held to the level announced in the President's program, the steel industry expects a minimum capital shortfall of about $1.5 billion annually for the next five years. This is the amount by which the capital that can be generated through income, borrowing, equity issues and other sources will fall short of the total that must be spent on capital equipment if we are to become more competitive. One way to substantially reduce that shortfall would be to change the tax laws to permit companies to obtain the cash benefit of investment tax credits and the tax effect of net operating loss carryovers. Steel companies have accumulated about $1-1/4 billion of investment tax credits which have been earned but couldn't be used because of low profitability. Net operating loss carryovers of about $6 billion would convert to almost $3 billion at a 46% statutory rate. Early access to the cash associated with these tax benefits is really only a timing item in the long run. With a 15 year carryover for each, we assume that sooner or later the benefits will be realized. By making the cash available now, during the period of the President's steel trade arrangements, we could make the investments which will help to produce profits, retain jobs and revitalize the industry. Many companies would be returned immediately to the position of taxpayers, thereby beginning to repay the money in the form of taxes.

The reasons for making the investment tax credit available are the same reasons that are advanced for tax reform in general - fairness and economic neutrality. The investment tax credit has worked in reverse. Profitable companies that do not make large capital investments have gotten the full measure of the credit, and these are the companies that need it the least. Low profit companies that are making large capital investments - those that could use the capital generated by the credit are frequently not able to use it on a current basis. As a result, over the years steel companies have built up excess credits which have been earned by making the same job-creating investment commitment as profitable companies, but could not be used due to a low level of profitability. If the investment tax credit is to be repealed, then any remaining balance should be paid out as rapidly as possible. Many companies will be able to reduce their continuing tax liability by residual credits and it would be equitable to make this benefit uniformly applicable to all. This payout could be limited to the amount of prior tax liability so as to make it in effect an offset to the prior taxes already paid.

The existing net operating loss carryover/carryback rules work well enough to average out the income and losses in normal business cycles. In fact, through 1981 they generally worked well enough for most steel companies despite some pretty bad years. However, things really went sour beginning in 1982 and massive losses continued to pile up even when the rest of the economy was returning to economic health. The system was simply incapable of dealing with such a departure from the norm. The policy decision on net operating losses has already been made -- that is that income and losses should be averaged over an extended period of time -- 19 years to be specific. What we would like to see is an economic decision to complement that policy decision. We believe that in extreme cases such as ours the law should be changed to permit an extended carryback of losses in order to get an immediate, rather than deferred cash benefit. This is not a unique position without some precedent. On about ten different occasions over the years, the inadequacy of the regular net operating loss carryover/carryback rules to deal with unusual situations has been recognized and dealt with separately.

We hope that during the course of the legislative process some way can be found to assist the steel industry as it struggles to survive in the face of numerous obstacles - including foreign government subsidization, dumping and the strong dollar. We look forward to working with the Committee to achieve that objective.

APPENDIX I.

### Analysis of Trade-off
### Loss of Investment Tax Credit
### Compared to 13 Percentage Point
### Rate Reduction
### Year 1981

(Dollar Amounts in Billions)

| | All Corporations | | | Total Assets of $250 Million or More | | |
|---|---|---|---|---|---|---|
| | Total | Manufacturing | All Other | Total | Manufacturing | All Other |
| # of Returns | 2,812,420 | 251,294 | 2,561,126 | 3,141 | 672 | 2,469 |
| 1) Total investment tax credit | 18.9 | 9.1 | 9.8 | 14.3 | 7.6 | 6.7 |
| 2) Total income subject to tax | 241.5 | 133.4 | 108.0 | 145.3 | 97.8 | 47.5 |
| 3) Total tax before credits | 102.3 | 59.6 | 42.7 | 65.4 | 44.3 | 21.1 |
| 4) Tax reduction from 13 percentage point rate reduction (46% to 33%) | 31.4 | 17.3 | 14.1 | 18.9 | 12.7 | 6.2 |
| 5) Net gain from tax reduction after loss of ITC (4-1) | 12.5 | 8.2 | 4.2 | 4.6 | 5.1 | (.5) |
| 6) Net gain as a % of initial total tax before credits (5 ÷ 3) | 12.2% | 13.8% | 9.8% | 7.0% | 11.5% | (1.0%) |

Source of statistics: 1981 Statistics of Income
Corporation Income Tax Returns
Internal Revenue Service Publication 16

## STATEMENT OF JOHN G. SMALE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE PROCTER & GAMBLE CO., CINCINNATI, OH

Mr. SMALE. Mr. Chairman, I am John Smale, president and chief executive officer of the Procter & Gamble Co. I have submitted my written statement for the record, so with your permission, my remarks are going to be very brief.

The CHAIRMAN. All of these statements will appear in the record in full.

Mr. SMALE. Procter & Gamble strongly supports tax reform designed to bring more equity to the Federal Tax Code. We think the key to tax reform for businesses is a substantial reduction in the corporate tax rate, by the elimination of as many deductions and special preferences as possible. We believe that the marketplace and not the Tax Code should provide the principal allocation of capital resources. We believe that a lower tax rate will help most businesses generate investment capital at a reasonable cost and it will encourage financing through equity rather than debt. We recognize that the elimination of current tax preferences will be painful, to one degree or another, to American industry.

Our company is no exception. But in a broad sense, we are willing to give up current preferences in order to achieve a more equitable and, in the long run, a more productive tax system for business. We believe that the deduction for a part of corporate dividends paid to shareholders is an important principle to be established to make a beginning toward the elimination of double taxation of corporate earnings. We believe that in your deliberations the committee should seriously examine a couple of aspects of the administration's proposal.

The first has been mentioned here before. That is the retroactive tax of earlier accelerated depreciation deductions. Not only does it seem unfair to change the rules after the fact, but if left in place, this would remove a significant amount of capital for business investment during the early phased-in years of the new tax law.

And second, we are concerned with major changes that affect retirement plans. These changes are not, to our knowledge, significant revenue issues, but we would urge the committee to take up changes in the retirement plan really as a separate matter.

In general, we are in strong agreement with the principles of the administration's proposal. We believe that tax reform needs to be revenue neutral. We believe it needs to eliminate as many exceptions and preferences as absolutely possible. And we think that the lower tax rates made possible by that will create a stronger economy for the future. Thank you.

The CHAIRMAN. Thank you very much.

[The written prepared statement of Mr. Smale follows:]

THE PROCTER & GAMBLE COMPANY

EXECUTIVE OFFICES
P. O. BOX 599 CINCINNATI, OHIO 45201

# STATEMENT
# OF

JOHN G. SMALE
PRESIDENT AND CHIEF EXECUTIVE OFFICER
THE PROCTER & GAMBLE COMPANY

BEFORE
THE

COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, D.C.

JUNE 13, 1985

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I AM JOHN G. SMALE, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF THE PROCTER & GAMBLE COMPANY. PROCTER & GAMBLE IS A WORLDWIDE CONSUMER PRODUCTS COMPANY WITH HEADQUARTERS IN CINCINNATI, OHIO. OUR SALES LAST YEAR WERE APPROXIMATELY $13 BILLION AND OUR AFTER TAX EARNINGS WERE $890 MILLION. AMONG OUR WELL KNOWN HOUSEHOLD CONSUMER PRODUCTS IN THIS COUNTRY ARE SUCH BRANDS AS IVORY SOAP, TIDE LIQUID AND POWDER DETERGENTS, CREST TOOTHPASTE, PAMPERS AND LUVS DISPOSABLE DIAPERS, CHARMIN TOILET TISSUE, HEAD & SHOULDERS SHAMPOO, CRISCO SHORTENING, AND THE DUNCAN HINES LINE OF PREPARED BAKING MIX AND READY-TO-SERVE COOKIE PRODUCTS. PROCTER & GAMBLE HAS ABOUT FORTY THOUSAND EMPLOYEES IN THE U.S. WITH 50 MANUFACTURING PLANTS IN 23 STATES. AN ADDITIONAL TWENTY-TWO THOUSAND EMPLOYEES ARE EMPLOYED IN VARIOUS MANUFACTURING AND MARKETING OPERATIONS ABROAD. WORLD-WIDE CAPITAL EXPENDITURES LAST YEAR EXCEEDED $900 MILLION AND WILL BE SOMEWHAT MORE THIS FISCAL YEAR.

OUR FEDERAL INCOME TAX PAYMENTS OVER THE PAST 10 YEARS HAVE TOTALLED ABOUT $3.3 BILLION. THIS IS AN AVERAGE EFFECTIVE RATE OF 36% OVER THE PERIOD. TAX PAYMENTS WERE SUBSTANTIALLY MORE THAN THE $2.7 BILLION OF DIVIDENDS WE PAID TO SHAREHOLDERS DURING THE SAME PERIOD.

PROCTER & GAMBLE STRONGLY SUPPORTS TAX REFORM AND TAX SIMPLIFICATION. THE TWO KEY ELEMENTS OF SUCH A PROGRAM ARE A SUBSTANTIAL REDUCTION IN INDIVIDUAL AND CORPORATE RATES AND A BROADENED TAX BASE WHICH ELIMINATES MANY OF THE DEDUCTIONS AND SPECIAL PREFERENCES WHICH ARE NOW IN THE TAX CODE.

WE BELIEVE REFORMING THE TAX SYSTEM WOULD RESULT IN CLEAR BENEFITS, INCLUDING:

- ALLOCATION OF RESOURCES THROUGH THE FREE MARKET WITHOUT ARTIFICIAL DISTORTIONS OR DISLOCATIONS CAUSED BY TAX CONSIDERATIONS.

- REDUCTION OF EXISTING PERCEPTIONS THAT THE PRESENT RULES ARE UNFAIR, AS WELL AS CORRECTION OF REAL INEQUITIES.

- ELIMINATION OF SOME OF THE COMPLEXITY OF PRESENT LAW WITH HIGHER LEVELS OF VOLUNTARY COMPLIANCE BY TAXPAYERS AND LOWER ADMINISTRATIVE COSTS FOR GOVERNMENT.

LET ME ADDRESS THE FIRST TWO POINTS IN GREATER DETAIL.

FIRST, RESOURCE ALLOCATION IN THIS COUNTRY HAS INCREASINGLY BEEN MADE FOR TAX RATHER THAN ECONOMIC REASONS. THE FREE MARKET'S ROLE IN BUSINESS INVESTMENT DECISIONS HAS BECOME LESS IMPORTANT THAN PROVISIONS IN THE TAX LAW WHICH UNDULY ENCOURAGE SELECTED ACTIVITIES OR ESTABLISH DISINCENTIVES FOR OTHERS. THE TAX CODE HAS BECOME AN UNOFFICIAL DE FACTO INDUSTRIAL POLICY FOR THE U.S., WHICH HAS DISPLACED THE FREE MARKET AS THE ARBITER FOR BUSINESS'S INVESTMENT DECISIONS.

THE FREE MARKET IS NOT A PERFECT MEANS OF ALLOCATING RESOURCES, BUT IT IS A MORE EFFECTIVE TOOL THAN COMPLICATED TAX RULES. SUCH RULES WERE USUALLY ADOPTED TO MEET WHAT SEEMED AT THE TIME TO BE DESIRABLE ECONOMIC, SOCIAL OR POLITICAL OBJECTIVES, BUT THEIR DRAFTERS COULD NOT ANTICIPATE THE CHANGES IN ECONOMIC CIRCUMSTANCES WHICH WOULD OCCUR THEREAFTER.

THE RESULT HAS FREQUENTLY BEEN THE MISALLOCATION OF INVESTMENT CAPITAL — MORE TO SOME INDUSTRIES AND BUSINESSES AND LESS TO OTHERS THAN THE FREE MARKET WOULD ALLOCATE. SINCE BOTH BUSINESS AND GOVERNMENT HAVE LIMITED RESOURCES, THERE HAS BEEN A RESULTANT LOSS IN PRODUCTIVITY AND OPPORTUNITY WHICH WE COULD ILL AFFORD IN TODAY'S INTERNATIONAL COMPETITION FOR SALES AND JOBS.

OUR CURRENT TAX RULES ALSO ENCOURAGE SUBSTITUTION OF TAX SAVINGS MOTIVES AS A MAJOR FORCE FOR BUSINESS INVESTMENT, INSTEAD OF THE CREATION OF JOBS OR PROFIT OPPORTUNITIES IN THE INVESTOR'S BUSINESS. BUSINESSES BECOME LESSORS OR BANKERS, ACQUIRING OWNERSHIP OF ASSETS TO LEASE TO OTHERS BECAUSE OF DEPRECIATION DEDUCTIONS AND TAX CREDITS. TAXES CAN BE REDUCED ON THE PROFITS FROM THE INVESTOR'S OWN BUSINESS, BUT THE IMPACT ON THE OVERALL ECONOMY, AND ON CAPITAL FORMATION IN CERTAIN INDUSTRIES, CAN BE CAPRICIOUS. I SUGGEST THAT THE COUNTRY'S LONG-TERM INTEREST REQUIRES A MORE NEUTRAL TAX CODE WHICH MAKES INVESTMENT IN ONE'S OWN BUSINESS AT LEAST AS ATTRACTIVE IN TERMS OF AFTER-TAX PROFITS AS INVESTMENTS IN UNRELATED BUSINESSES.

THE BUSINESS COMMUNITY IS NOT IN COMPLETE AGREEMENT THAT THE FREE MARKET ALLOCATES ECONOMIC RESOURCES BETTER THAN INFORMAL CENTRAL PLANNING THROUGH THE TAX CODE. SOME FIND THE CURRENT TAX RULES WITH THEIR HIGH RATES, COMPLEXITY AND NARROWLY FOCUSED SPECIAL INTEREST PROVISIONS MORE DESIRABLE. IN MY VIEW, HOWEVER, THERE WILL BE MORE EFFICIENT ALLOCATION OF OUR LIMITED ECONOMIC RESOURCES WITH A MORE NEUTRAL TAX SYSTEM WHICH LETS THE FREE MARKET EXERT ITS INFLUENCE FULLY. I FIRMLY BELIEVE THAT THIS WILL LEAD TO MORE SUSTAINED ECONOMIC GROWTH.

A SECOND BENEFIT OF TAX REFORM AND SIMPLIFICATION WOULD BE INCREASED EQUITY AND FAIRNESS. OUR VOLUNTARY COMPLIANCE SYSTEM IS UNDER STRAIN BECAUSE A MAJORITY OF

THE PUBLIC DOES NOT BELIEVE IT IS FAIR. THIS TAXPAYER PERCEPTION OF UNFAIRNESS HAS BEEN CONFIRMED REPEATEDLY IN IRS AND PUBLIC OPINION POLLS. IF THIS PERCEPTION OF UNFAIRNESS IS NOT CORRECTED, THE SYSTEM WILL ULTIMATELY COLLAPSE.

MOST TAXPAYERS FIND TWO THINGS IN THE CURRENT TAX SYSTEM HIGHLY OBJECTIONABLE. FIRST, IT BENEFITS HIGH INCOME TAXPAYERS AT THE EXPENSE OF THE MIDDLE CLASS. SECOND, IT PERMITS SOME CORPORATE TAXPAYERS TO PAY LITTLE OR NO TAX; IN THEIR MINDS, BUSINESS IS BEING UNDERTAXED.

THE PERCEPTION THAT BUSINESS FAILS TO PAY ITS FAIR SHARE OF TAXES IS CONSTANTLY BEING REINFORCED BY NEW REPORTS ABOUT PROFITABLE BUSINESSES WHICH AVOID PAYING ANY SIGNIFICANT FEDERAL INCOME TAXES. THIS MUST BE A MATTER OF CONCERN FOR ALL BUSINESSMEN. WHAT THE GENERAL PUBLIC BELIEVES ABOUT CORPORATE AMERICA AND HOW IT CONDUCTS ITS AFFAIRS IS IMPORTANT -- IMPORTANT TO THE COUNTRY AND TO THE BUSINESS COMMUNITY. BUSINESS SHOULD SUPPORT RESPONSIBLE TAX SIMPLIFICATION AND REFORM TO CORRECT THIS PERCEPTION IF FOR NO OTHER REASON.

THERE ARE REAL INEQUITIES IN CURRENT LAW AS WELL AS PERCEIVED INEQUITIES. THE TAX BURDEN FALLS UNEVENLY ON SIMILARLY SITUATED TAXPAYERS -- BOTH CORPORATE AND INDIVIDUAL. SOME CAN REDUCE THEIR TAX OBLIGATIONS USING SPECIALIZED PROVISIONS OR TAX INCENTIVES, BUT OTHERS WITH ROUGHLY EQUAL INCOMES DO NOT HAVE THE SAME OPPORTUNITY.

THE TAX SYSTEM SHOULD BE AS ECONOMICALLY NEUTRAL AS POSSIBLE BETWEEN SIMILARLY SITUATED TAXPAYERS. THIS IS TRUE FOR INDIVIDUALS, FOR COMPANIES WITHIN THE SAME INDUSTRY, AND FOR THE VARIOUS INDUSTRIES WHICH MAKE UP OUR INDUSTRIAL COMPLEX. IF

SPECIAL CIRCUMSTANCES OR NATIONAL INTERESTS REQUIRE ENCOURAGEMENT OF CONDUCT OR AID TO AN INDUSTRY, THIS SHOULD BE PROVIDED DIRECTLY, AND NOT THROUGH THE TAX CODE.

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TAXPAYER DISSATISFACTION WITH THE PRESENT SYSTEM HAS CREATED A FAVORABLE CLIMATE FOR TAX REFORM. THIS GIVES THE TAX WRITING COMMITTEES AND CONGRESS A RARE OPPORTUNITY TO MAKE SUBSTANTIVE CHANGES. THE GOAL SHOULD BE A SET OF RULES WHICH ARE PERCEIVED TO BE FAIRER, SIMPLER, AND MORE ECONOMICALLY NEUTRAL FOR ALL TAXPAYERS WITH A BROADENED TAX BASE AND DRAMATICALLY LOWER RATES. THIS WILL ENCOURAGE ECONOMIC GROWTH AND PRODUCTIVITY. LET'S LET THE MARKET AND NOT TAX RULES ALLOCATE RESOURCES.

THE CHANCE TO REFORM THE SYSTEM AND SWEEP AWAY THE COMPLEXITY AND UNDERBRUSH OF SEVERAL DECADES ONLY COMES ONCE IN A GREAT WHILE. WE MUST NOT WASTE IT.

THE COMPREHENSIVE TAX REFORM PROPOSAL WHICH PRESIDENT REAGAN PRESENTED ADDRESSES SOME OF THE PROBLEMS I DESCRIBED. THE TAX CODE WOULD BE SIMPLIFIED IN SOME IMPORTANT WAYS FOR INDIVIDUALS. THE TAX CODE WOULD BE FAIRER AND MORE EVENHANDED IN DEALING WITH SIMILARLY SITUATED INDIVIDUAL TAXPAYERS. THE PROPOSAL IS A STEP TOWARD REFORM OF THE SYSTEM ALTHOUGH WE WOULD PREFER A BOLDER APPROACH WHICH CUTS AWAY MORE EXCEPTIONS AND PREFERENCES. STILL, IT IS A BEGINNING.

LET ME MENTION TWO DESIRABLE SPECIFICS. THESE ARE THE LOWER CORPORATE TAX RATE OF 33% AND THE NEW DEDUCTION FOR 10% OF DIVIDEND PAYMENTS TO SHAREHOLDERS. THEY

SHOULD HELP MOST BUSINESSES GENERATE BUSINESS INVESTMENT CAPITAL AT REASONABLE COST. RESTORATION OF THE FREE MARKET'S ROLE IN BUSINESS DECISION MAKING THROUGH ELIMINATION OF MANY SPECIAL INTEREST PROVISIONS WILL ENCOURAGE USE OF THIS ADDED INVESTMENT CAPITAL IN WAYS WHICH WILL PROVIDE MAXIMUM BENEFITS TO THE ECONOMY.

THE DESIRABILITY OF A DEDUCTION FOR PART OF THE CORPORATE DIVIDENDS PAID TO SHAREHOLDERS IS WORTH EMPHASIZING. IT MARKS A BEGINNING TOWARD ELIMINATING THE DOUBLE TAXATION OF CORPORATE EARNINGS AT BOTH THE CORPORATE AND SHAREHOLDER LEVELS. THE 10% RATE OF DEDUCTION IS UNDULY MODEST. I WOULD ASK THE COMMITTEE TO CONSIDER WHETHER IT CAN BE INCREASED NOW OR IN THE NEAR FUTURE. THE DEDUCTION SHOULD GENERATE ADDITIONAL BUSINESS INVESTMENT.

PRESENT LAW ENCOURAGES BUSINESS TO FINANCE ITS OPERATIONS THROUGH DEBT INSTEAD OF THROUGH ADDITIONAL EQUITY CAPITAL. ALLOWING A DEDUCTION FOR DIVIDEND PAYMENTS SIMILAR TO THE INTEREST DEDUCTION WILL REMOVE SOME OF THIS BIAS. THE RESULT SHOULD BE A STRENGTHENED FINANCIAL POSITION FOR MANY CORPORATE BUSINESSES.

DRAMATIC CUTS IN INDIVIDUAL AND CORPORATE TAX RATES WILL ONLY BE POSSIBLE IF THE TAX BASE IS SUBSTANTIALLY BROADENED. OTHERWISE THE PROPOSAL COULD NOT BE REVENUE NEUTRAL. THE ADMINISTRATION PROPOSAL TRIES TO DO THIS IN A LIMITED WAY. MANY OF US -- BUSINESS AND INDIVIDUALS ALIKE -- WILL HAVE TO GIVE UP SOME OF THE DEDUCTIONS, CREDITS, AND SPECIALIZED TAX TREATMENT WHICH WE HAVE COME TO ACCEPT. THIS MAY BE PAINFUL, BUT THE LOWER RATES AND A FAIRER TAX SYSTEM JUSTIFY THE CHANGES.

FOR PROCTER & GAMBLE, LOSS OF THE INVESTMENT TAX CREDIT, SOMEWHAT SLOWER CAPITAL RECOVERY BECAUSE OF SLOWER TAX DEPRECIATION, AND OTHER MANDATED ACCOUNTING CHANGES, WILL REDUCE OUR CASH FLOWS. THIS COST WOULD NOT BE FULLY OFFSET BY REDUCED RATES OR DEDUCTIONS FOR DIVIDENDS IN THE INITIAL PERIOD FOLLOWING REFORM EVEN IF ALL TAX BENEFITS AND TAX DETRIMENTS TOOK EFFECT SIMULTANEOUSLY. AS DISCUSSED LATER HOWEVER, THE EFFECTIVE DATES FOR VARIOUS PARTS OF THE PROPOSAL ARE NOT THE SAME SO THAT THE ADVERSE EFFECTS ON CASH FLOWS ARE EVEN GREATER.

PROCTER & GAMBLE IS WILLING TO ACCEPT THE COST OF ALL THESE TAX CHANGES AS PART OF AN OVERALL TAX REFORM AND RATE REDUCTION PROGRAM, BUT ONLY IF IT IS APPARENT THAT THE FINAL BILL TREATS ALL INDUSTRIES FAIRLY AND EQUITABLY.

THE NEW PROPOSALS STILL RETAIN SOME SELECTED SPECIAL INTEREST TAX PROVISIONS THAT PERPETUATE ECONOMIC DISTORTIONS WHICH HAVE BEEN A CONTINUING PROBLEM UNDER THE PRESENT RULES. I URGE THE COMMITTEE TO CONSIDER THESE CAREFULLY AND DETERMINE WHETHER THEY SHOULD BE ELIMINATED.

EQUALLY, I URGE THE COMMITTEE, IN THE PROCESS OF ITS DELIBERATION, NOT TO LOAD UP THE TAX CODE WITH ADDITIONAL PROVISIONS AND EXCEPTIONS WHICH MIGHT FAVOR SOME INDUSTRIES BUT WHICH DETRACT FROM THE BASIC PRINCIPLES OF A BROAD-BASED, LOW RATE, FAIR AND SIMPLE TAX CODE.

WE SHOULD NOT USE THE TAX CODE TO TRY TO SOLVE THIS COUNTRY'S FOREIGN TRADE DEFICIT, OR THE BALANCE OF PAYMENTS PROBLEM, OR TO PROTECT NATIONAL SECURITY INTERESTS OR BALANCE "FROST BELT" VERSUS "SUN BELT" ISSUES. ALL OF THESE ISSUES ARE IMPORTANT TO OUR NATION'S SHORT AND LONG-TERM ECONOMIC HEALTH. THEY SHOULD BE CONSIDERED SPECIFICALLY AND NOT HANDLED INDIRECTLY IN TAX LEGISLATION.

THREE ASPECTS OF THE ADMINISTRATION PROPOSAL ARE OF CONCERN AND WARRANT SPECIFIC

MENTION. THESE ARE: (A) THE PROPOSAL TO SUBJECT PART OF BUSINESS'S ACCELERATED DEPRECIATION DEDUCTIONS CLAIMED BETWEEN 1980 AND MID-1986 TO SPECIAL TAXATION; (B) THE TIMING "MISMATCH" BETWEEN THE LOWER TAX RATES AND THE ELIMINATION OF EXISTING TAX BENEFITS, AS WELL AS THE ABSENCE OF ADEQUATE TRANSITION RULES FOR SOME TRANSACTIONS; AND (C) THE PROPOSALS RELATED TO RETIREMENT PLANS.

TAX HISTORY WOULD BE REWRITTEN IF THE PROPOSAL TO TAX PART OF ACCELERATED DEPRECIATION DEDUCTIONS TAKEN OVER THE LAST FIVE YEARS WERE ADOPTED. THE PROPOSAL IS NECESSARY, ACCORDING TO ITS PROPONENTS, TO ELIMINATE A WINDFALL ADVANTAGE WHICH IS OPENED BY THE RATE CUTS. IN MY JUDGMENT, IT REQUIRES YOUR CAREFUL REVIEW FOR SEVERAL REASONS.

FIRST, IT AFFECTS ONLY BUSINESSES WHICH HAVE MADE SIGNIFICANT INVESTMENTS IN CAPITAL EQUIPMENT OVER THE PAST FIVE YEARS. THESE INVESTMENTS HELPED FUEL THE STRONG ECONOMIC RECOVERY WHICH STIFLED INFLATION, REDUCED INTEREST RATES AND CREATED JOBS AT RECORD LEVELS. NOW, THE BUSINESSES WHICH MADE THESE INVESTMENTS WOULD BE DENIED PART OF THE BENEFIT OF LOWER TAX RATES WHICH ALL OTHER TAXPAYERS WOULD RECEIVE.

NEXT, THE BUSINESSES WHICH WOULD BE REQUIRED TO PAY THIS ADDED TAX MUST PAY PART OF IT BEFORE THEIR CASH FLOWS REFLECT ANY BENEFIT FROM RATE REDUCTIONS OR DEDUCTIONS FOR DIVIDENDS PAID. THIS, COUPLED WITH THE LOSS OF THE INVESTMENT TAX CREDIT, WILL SERIOUSLY REDUCE THEIR POOL OF INVESTMENT CAPITAL IN THE PERIOD IMMEDIATELY FOLLOWING ENACTMENT OF TAX SIMPLIFICATION. THE SHORT-TERM IMPLICATIONS OF THIS ON OUR COUNTRY'S ECONOMIC GROWTH ARE OBVIOUS AND NEED YOUR SERIOUS CONSIDERATION.

FINALLY, THIS NOVEL TAX POLICY RETROACTIVELY SINGLES OUT ONE TYPE OF DEDUCTION WHICH WAS TAKEN IN GOOD FAITH AS MUCH AS FIVE YEARS EARLIER, AND INDIRECTLY IMPOSES A SPECIAL TAX ON IT. SHOULD THIS RETROACTIVE TAX BE REJECTED, REVENUES WHICH ARE LOST BECAUSE OF THIS COULD BE REPLACED BY ELIMINATING OTHER PREFERENCES, ADJUSTMENTS IN DEPRECIATION SCHEDULES, ETC.

ANOTHER MAJOR CONCERN IS THE EFFECTIVE DATES OF THE BASE BROADENING PROVISIONS VERSUS THE TIME WHEN LOWER RATES WOULD APPLY, AND THE ABSENCE OF ADEQUATE TRANSITION RULES.

MANY IMPORTANT CORPORATE BASE BROADENING AND TAX PROVISIONS — ELIMINATION OF THE INVESTMENT TAX CREDIT, THE "WINDFALL" DEPRECIATION RECAPTURE PROVISION, AND THE NEW TAX DEPRECIATION SYSTEM — WOULD BE PUT IN PLACE JANUARY 1, 1986. REDUCED CORPORATE RATES WOULD TAKE EFFECT SIX MONTHS LATER. THE PARTIAL DEDUCTION FOR DIVIDENDS PAID WOULD BECOME OPERATIVE SIX ADDITIONAL MONTHS LATER. THIS WOULD HAVE A VERY NEGATIVE EFFECT ON CORPORATE CASH FLOWS. WE STRONGLY URGE THAT ALL ELEMENTS OF THE PROPOSAL — THE GOOD AND THE BAD ALIKE — SHOULD BE PHASED IN TOGETHER. TO DO OTHERWISE WOULD BE UNFAIR.

AS TO TRANSITION RULES, SOME FORM OF BINDING CONTRACT RULE IS NEEDED. SECRETARY BAKER HAS ALREADY RECOGNIZED THIS ON BEHALF OF THE ADMINISTRATION, AND THE COMMITTEE WILL NEED TO ESTABLISH THE SPECIFICS.

AS GUIDELINES, WE SUGGEST THAT TRANSACTIONS IN PROGRESS, OR THE PLANNING OF WHICH IS FAR ADVANCED, MAY WARRANT PROTECTION BY RETAINING PRESENT LAW FOR THEM DURING A TRANSITION PERIOD. EXISTING TRANSACTIONS OF A LONG TERM NATURE, SUCH AS LONG TERM LEASES MAY ALSO NEED TO BE GRANDFATHERED UNDER THE PRESENT RULES.

NONETHELESS, THE NEED FOR FAIRNESS AND FOR GRANDFATHERING SHOULD NOT BE SEEN AS A JUSTIFICATION OR EXCUSE FOR DELAYING THE SUBSTANTIAL RATE CUTS WHICH TAX REFORM DEMANDS. ALSO, TRANSITION RULES SHOULD NOT BE USED TO RESTORE TAX BENEFITS OR RETAIN THEM LONGER THAN NECESSARY.

MY FINAL CONCERNS RELATE TO THE RETIREMENT PLAN PROVISIONS IN THE ADMINISTRATION'S PROPOSALS. SOME OF THE CHANGES BEING PROPOSED WHICH RELATE TO RETIREMENT DISTRIBUTIONS FROM QUALIFIED RETIREMENT PLANS ARE A MAJOR BREAK FROM RULES WHICH HAVE BEEN IN PLACE DURING MANY EMPLOYEES' ENTIRE WORKING LIVES. THE IMPLICATIONS OF THE CHANGES TO EMPLOYEES APPROACHING RETIREMENT ARE SUBSTANTIAL. FOR EXAMPLE, THE PROVISION IMPOSING EXCISE TAX PENALTIES ON RETIREMENT PAYMENTS MADE PRIOR TO AGE 59-1/2 COULD HAVE A CHILLING EFFECT ON POSSIBLE EARLY RETIREMENTS BY EMPLOYEES IN BOTH THE PUBLIC AND PRIVATE SECTORS. OTHER CHANGES COULD DOUBLE THE TAX ON SOME RETIREMENT DISTRIBUTIONS, AND SUBJECT OTHER RETIREMENT PAYMENTS TO EXCISE TAX PENALTIES. ALSO, THE RULES WHICH RELATE TO PROFIT SHARING PLANS ARE OF PARTICULAR CONCERN TO MY COMPANY WHICH HAS THE OLDEST CONTINUOUS PROFIT SHARING PLAN IN THE U.S. THE CURRENT PROPOSAL COULD CAUSE US TO MAKE MAJOR REVISIONS IN THIS PLAN WHICH HAS OPERATED WELL IN ITS PRESENT FORM FOR 40 YEARS.

ALL OF THESE CHANGES AFFECT EMPLOYEE RETIREMENT EXPECTATIONS FROM THE LOWEST PAID TO THE MANAGERS OF THE BUSINESS. THEY MUST BE CAREFULLY STUDIED FOR FAIRNESS TO AVOID A BREACH OF FAITH BETWEEN GOVERNMENT AND PLAN PARTICIPANTS. THE CHANGES DESERVE MORE ATTENTION THAN THEY ARE LIKELY TO GET IN A TAX REFORM BILL OF THIS MAGNITUDE, WHICH APPEARS TO BE ON A "FAST TRACK" FOR LEGISLATIVE CONSIDERATION. SINCE THE REVENUE EFFECTS OF THESE RETIREMENT PROVISIONS ARE NOMINAL AT BEST, I WOULD URGE THE COMMITTEE TO REMOVE THEM FROM THE CURRENT PROPOSAL AND TAKE THEM UP AS PART OF AN OVERALL RETIREMENT INCOME STUDY.

IN SUMMARY, I BELIEVE THAT THIS COUNTRY URGENTLY NEEDS TO SIMPLIFY THE CURRENT INCOME TAX CODE. MAJOR RATE REDUCTIONS AND A BROADENED TAXABLE BASE WILL RESULT IN MORE EFFICIENT ALLOCATION OF RESOURCES BY THE MARKETPLACE, AND ECONOMIC GROWTH OVERALL. THE ADMINISTRATION'S PROPOSALS GIVE THIS COMMITTEE A REASONABLE FRAMEWORK FOR DEVELOPING A DESIRABLE TAX REFORM PACKAGE.

I AGAIN URGE YOUR COMMITTEE TO AVOID TRADING AWAY TAX REFORM OR COMPROMISING THE RATE REDUCTIONS TO PROTECT PROVISIONS WHICH FAVOR EXISTING VESTED INTERESTS. BY DOING SO, YOU WILL RESTORE THE MARKETPLACE AS A PRIMARY FORCE IN BUSINESS DECISION-MAKING AND ELIMINATE THE ARTIFICIAL ALLOCATION OF FINANCIAL RESOURCES CURRENTLY INDUCED PRIMARILY BECAUSE OF TAX CONSIDERATIONS.

IT IS IMPOSSIBLE TO RETURN TO A TRULY SIMPLE TAX LAW, BUT I HOPE THAT THE COMMITTEE CAN ELIMINATE MUCH OF THE COMPLEXITY OF THE PRESENT TAX RULES AND, MOST IMPORTANT, MAKE OUR TAX LAWS FAIRER THAN THEY NOW ARE.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, THANK YOU FOR THE OPPORTUNITY TO APPEAR BEFORE YOU. FOLLOWING COMPLETION OF THE TESTIMONY OF THE REMAINING PANEL MEMBERS, I WOULD BE PLEASED TO ANSWER ANY QUESTIONS WHICH YOU MIGHT HAVE.

The CHAIRMAN. We follow in this committee the "early bird rule" and the first Senator here gets to ask questions first. The order I have is Senators Long, Moynihan, Packwood, and Bradley. Senator Long?

Senator LONG. Thank you, Mr. Chairman. Mr. Trautlein, were you the head of a large accounting firm before you came here?

Mr. TRAUTLEIN. I was a partner, a senior partner in Price Waterhouse.

Senator LONG. Price Waterhouse?

Mr. TRAUTLEIN. Yes, indeed.

Senator LONG. All right. Now, Mr. Shapiro used to work for our Joint Tax Committee. Your firm hired him. Were you still there when you hired him?

Mr. TRAUTLEIN. No, I left before Mr. Shapiro came in.

Senator LONG. I think you hired a good man, and we lost a good man when Price Waterhouse hired him. He used to go before tax lawyers, and when they got on the subject of complexity, he would say, well, if you want to know where the complexity came from and why it is there—he would point this out—he would say you tax lawyers have been up here, year by year, with each of you having something that you said would give us more perfect equity and give us better justice by your clients. And time and again, you persuaded the Congress to go along with that. Barber Conable recently wrote an article—perhaps you have seen it—I imagine it would be of interest if you ran across it. He was one of the senior Republicans on the House Ways and Means Committee.

Mr. TRAUTLEIN. Yes, sir.

Senator LONG. And he made this point—that the complexity in our code in the main is not there because of some mischief. Most of it is there in the effort of Congress to do more perfect justice. Now, coming from where you do, I think you are somewhat familiar with that problem. There are just a lot of things we have in the Tax Code that are there—and I am not talking about the 1040 EZ, and I am not talking about the 63 percent that don't itemize—but as far as corporations like you represent, most of those things are there because your lawyers—tax lawyers—even Price Waterhouse came up and said now, here is something that is wrong about this, and all you have to do is put one more paragraph in there and that will take care of it. Now, how are we going to overcome that particular problem in simplicity? I can see how it can make it simple for 63 percent of the taxpayers, and it is pretty simple for them already. But aren't we still going to need Price Waterhouse and Arthur Andersen and others to fill out our tax returns for us if our business is complicated and we are all very successful and make a lot of money?

Mr. TRAUTLEIN. Yes, but I think regardless of what we do, we are not going to just take all revenue and have a flat tax on it. There are still going to be provisions in the law, and we have seen the movement from Treasury 1 to the President's proposal in that regard. I would just make a comment. I don't know if it is directly in response to your question, but one thing that does concern me, and we have all touched on it a little bit here, is the need to consider our tax laws in a worldwide environment as well as—and I think maybe even more importantly—than a national environment because all of us are competing in the international market. And one of the things, when we had the ACRS together with the investment tax credit, we had a capital recovery system that was competitive.

Now, one of the things that concerns us and the only way you retain something that is reasonably the same is by the rate reduction. But it would be catastrophic, I think, if we would not have the kind of rate reduction we have, to lose the investment tax credit. We have to look—we certainly in business are looking—at the international environment, not just the national situation. So, if we have a disadvantage with international competition in terms of our tax laws, you can see where the capital is going to go and where the jobs are going to go.

Senator LONG. Let me ask you a question, Mr. Smith. Some time ago, we asked the Treasury to give us a tabulation to show us how many people got by without paying any taxes. They gave us such a tabulation, and we wanted to know why they paid so little taxes. And so, we take the list of those who made a lot of money and according to that tabulation paid little taxes. The largest group of those who were paying nothing were people who had claimed the advantage of the foreign tax credit and pay a lot of money to a foreign government. And about second in line or third—among the top group—casualty losses—somebody's house burned down, and he had to pay for it and he had a right to claim it as a loss.

Now, how are we ever going to get that perception straight when we have people up here who do like some—and I won't name them but you know who they are, and the names would be familiar if I called their names—who just annually get out of paying. So many people paid no tax. For example, if you made a lot of money overseas and you brought it back in here, you would pay 70 percent over there, so here the rate is less and because of credit you owe none. How are we going to get you a good perception when the fact is that, according to any fair standard, you didn't owe any taxes? And yet, they go out and say, as they say about some people, General Motors paid no tax.

Mr. SMITH. It is a problem, Senator, that we don't have to deal with right now. We paid $5.3 billion in taxes last year, so our problem is not being among those who didn't pay the taxes. What we would like to do is see the burden spread equally and get the kind of tax reform where everybody pays taxes. So, being a wealthy nontaxpayer has not been our case. We have been paying a substantial amount in taxes.

Senator LONG. I am not talking about your company in this case. I am asking a hypothetical question. I just want to know about the fellow who paid 70 percent of his income overseas, and he claimed the foreign tax credit, as a result of which he paid no tax over here. Do you think we ought to put more taxes on him?

Mr. SMITH. I think that you have to approach that through the minimum tax.

Senator LONG. And add an additional tax on top of that?

Mr. SMITH. I think that is what it has to be. We have got to have the issue of fairness perceived by all the people.

Senator **Long**. The problem that affects me is that if a man has already paid his fair share, if he paid 70 percent, the question in my judgment is should we still put more on him?

Mr. **Smith**. Again, I think you have to look at that on a balanced basis. Most of the companies I know don't have strictly overseas operations. They have overseas and U.S. operations, so I don't know too many taxpayers that are overseas only in that case.

Senator **Long**. Thank you, Mr. Chairman.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Thank you, Mr. Chairman. I would like to put a simple question to the panel and if each in turn would respond, as they have testified. One of the concerns that our committee has heard and that the Ways and Means Committee has heard is that the proposal we have before us is not revenue neutral. It costs. It will not raise as much as it attributes, and so it will add to the deficit. The rates can vary, and the estimates over 5 years go from a minimum of $200 billion, I have heard, to as much as $300 and $400 in added deficit over 5 years.

Basically, this comes down to what assumptions do you use on economic growth that bring in the returns from different rates. But on the other hand, we have heard Mr. Smith of GM, we will hear Mr. Smith of General Foods say that the recapture provision on the accelerated cost recovery are not fair. They are a retroactive tax increase, so we took those out. A case has been made, so the revenue loss is greater. If a fair judgment of the economic community is that these proposals would add, say, $200 billion to the deficit over the next 5 years, would you be in favor of them or against them? Mr. Smith, Mr. Smale, Mr. Trautlein, and then Mr. Bryan.

Mr. **Smith**. Certainly, as we said in our statement, one of the purposes of taxes is to raise the revenues that we need to operate the Government. So, obviously, we would not be in favor of a program that adds to the budget deficit, but I do believe you can achieve that within it. Now, I know there are wide variances between estimates of income and estimates of taxes and the revenues from them. And it is difficult, particularly in projecting 5 years out, to know which of those is the best estimate, but I submit you have to go with some—

Senator **Moynihan**. You would have us pay attention to whether this is going to add to the deficit?

Mr. **Smith**. If it added to the deficit, I think we should go back and reexamine it because the deficit problem is bad enough now.

Mr. **Smale**. Absolutely. I agree with that Senator, although I am not sure that the issue of neutrality on revenue and reform of quality in the Tax Code are necessarily tied together.

Senator **Moynihan**. In a different context, they might be different, but in the context of a permanent $200 billion deficit making it $300 would not be a good idea?

Mr. **Smale**. I don't think so.

Senator **Moynihan**. Mr. Trautlein.

Mr. **Trautlein**. In a word, your question was: Would I be in favor of it if it increased the deficit by $100 billion? The answer is no.

Senator **Moynihan**. I didn't mean to make it that simple.

**Mr. TRAUTLEIN.** Yes. Well, let me say this. I think these are separate and distinct questions, and we have to address the Federal deficit question, and I think the President is right, and I think the Senate was more right. We have got to address it through spending reductions. That is where the problem comes, as I say in my written statement. When you look at the fact and the 4 years, I think the percentage of spending has grown by 44 percent, and it hasn't been a revenue shortfall. It has been too damned much spending.

Senator **MOYNIHAN.** On what—defense?

**Mr. TRAUTLEIN.** I think there is plenty of room across the board.

Senator **MOYNIHAN.** We were spending $150 billion on interest on the public debt. Do you think we are spending too much on that?

**Mr. TRAUTLEIN.** Sure we are. The reason we are spending that is that we are spending too much on the programs. It is a circular kind of thing. I think we have to look at all the programs, and I certainly hope that this Congress will address that problem. You know, what I would like to see is take the best out of what——

Senator **MOYNIHAN.** Has the President ever sent us a balanced budget, sir?

**Mr. TRAUTLEIN.** I don't believe so.

Senator **MOYNIHAN.** No, nothing near. Mr. Bryan.

**Mr. BRYAN.** We have been told and are operating under the assumption that it is, in fact, revenue neutral. We don't have any reason to believe otherwise. I think it certainly is appropriate for your committee to challenge that assumption.

Senator **MOYNIHAN.** I didn't mean to cut you off, sir, but my time is limited. Martin Feldstein, who is the first chairman of the Council of Economic Advisors, has testified that this looks very prominently suspicious to him. Remember, 4 years ago we had a tax bill in front of us which was going to reduce tax rates but not lose a penny of revenue, and out of it came a permanent $200 billion deficit, doubling of the national debt in 4 years. The largest growing item in our budget is interest payments, about which we have no option. Mr. Chairman, may I just say that I have to be on the floor at 10 o'clock for the Clean Water Act.

The **CHAIRMAN.** Oh, you have the Clean Water Act, don't you?

Senator **MOYNIHAN.** Thank you, gentlemen, very much.

The **CHAIRMAN.** The reason Senator Moynihan poses that question is it is a very valid question. As you are well aware, this recapture provision on the investment tax credit crept into this bill rather late, and it crept into the bill late because the bill was short of money, and it was not going to be revenue neutral. And you must understand that Secretary Baker's definition of revenue neutral is that we estimate that our revenues over the next 5 years will be $4.7 trillion, and if we can come within 1 percent of that, plus or minus, the bill is revenue neutral. So, we have about $100 billion leeway to play with. Even with that leeway, the administration at the last moment had to suggest the recapture provision in order to even get it up to minus 1 percent. And what Senator Moynihan and many of us are afraid of is that we think when we get to the end of this bill, we may be a couple hundred billion dollars short. Then, what do we do? Where do we get the money? Do we put the corporate tax rate at 38 percent or 40 percent? Do we raise the individual rates 2 or 3 percent and make it 18, 28, and 38? That is our fear—that we may be short. Let me ask a question, starting with Mr. Smith, and then moving right down the line because I presume that you are all generally testifying that the Tax Code ought to be neutral. It shouldn't favor cars over steel, or cookies over anything else. Is that a fair assumption, to start with?

Mr. SMITH. Yes, it is.

Mr. SMALE. Correct.

The CHAIRMAN. All right.

Mr. TRAUTLEIN. I would just say in the context of international tax laws, I would like to look at this at a broader—

The CHAIRMAN. I understand that, and I am going to get to that point in a minute, but basically, if for whatever reason the international community chooses to favor subsidizing steel, whether through the Tax Code or direct subsidies, in that case what do we do, when we are faced with an international market?

For the moment, let's assume that at least what we are striving for is neutrality. Now, let's come to the argument of the oil and gas industry and the intangible drilling costs. In Treasury I, the intangible drilling costs were eliminated. Then, the argument was made that from the standpoint of national security, we have to have energy and especially oil and gas, and without the intangible drilling costs being deducted, we won't have it.

First, in answering the question, let's accept as a "given" that we need oil and gas for national security. We cannot be neutral in that area. Now, if that is a given, and if we didn't use the Tax Code for that purpose, that is, giving them the deductions for the intangible drilling costs, what should we do? What should be the form of the Government protection, help, or subsidy to achieve it? Mr. Smith.

Mr. SMITH. I think there are many ways that you can do that, but I would say—as I believe Mr. Trautlein said—you shouldn't use the Tax Code to try and promote national defense. That is a different thing, and in doing so, you may lose the whole fairness issue that I think the tax reform is trying to generate.

The CHAIRMAN. I understand that, but give me some suggestions of what we should do as an alternative therefor if it is necessary to protect the oil and gas industry. In this case, it wasn't much protection against foreign competition. They just said there won't be any drilling here and consequently no development.

Mr. SMITH. I hesitate to suggest another farm program, but there certainly have been other methods that we have seen in terms of low-cost financing being made available and other things that you can do within the powers of the Government. And I think again if you do those, then you don't lose the fairness issue in the Tax Code, which I think is very important, but certainly, Government subsidized loans, direct aid as we do in the farm programs, price supports that we have done, I think you have to be careful not to violate the GATT issues. But I think there is plenty of room to do it outside of the code.

The CHAIRMAN. That is a fair answer, but then the rest of you could address yourselves to this. There are other things we can do. Indeed, the farm programs and the direct subsidies for farm supports is an example. The synthetic fuels corporation is an example. We set it up for alternative energy. We were going to make gigantic loans to small and medium companies. The thing has turned out to be a boondoggle.

The point I would make is this, and in answering the question, address yourselves to it: If for some reason we think something needs to be encouraged beyond the marketplace, whether it is for national security or other legitimate reasons, it seems to me we have two ways to do it. One is to use the Tax Code, and the other is a straight-out Government subsidy or Government program. And for years at least, many of us have thought that the Tax Code was a more effective and efficient way to do it than Government-managed, Government-run, Government-loaned, and on occasion Government-owned programs.

Given those two choices, are you still saying you would rather go the subsidy route, with all that goes with it and the Government management that goes with it, as opposed to the use of the Tax Code for incentives?

Mr. SMITH. I would say yes.

Mr. SMALE. I would say yes, too.

Mr. TRAUTLEIN. I would suggest there are other ways, too. One that has been suggested, of course, is some sort of a duty or tariff on imported oil. That would also raise revenue, and it would help bring a price level that would perhaps allow the investment to be made.

Mr. BRYAN. Specifically, with regard to oil, I think it is possible to question the premise that the defense of the Nation depends on the oil subsidy.

The CHAIRMAN. We will get to that debate. Just for purposes of answering the question, presume it. When we get to debating it, it is going to be an issue that is going to come up—whether or not indeed the premise is even valid.

Mr. BRYAN. Certainly, the building of the oil reserves would be one way. However, I would clearly favor direct subsidy to the oil industry as opposed to using the Tax Code as a means of getting that to them.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman. I must say this last exchange is surprising to me. I thought that all of you gentlemen were fairly committed to the functioning of the market, and I didn't realize the energy marketplace was any different than cars or consumer goods or food or steel.

The CHAIRMAN. But in fairness, I made the premise of national security.

Senator BRADLEY. Pardon.

The CHAIRMAN. I made them assume the premise of national security and the need for it.

Senator BRADLEY. I see. Would any of you like to reconsider your answer to the previous question?

Mr. SMITH. I think that we are all responding to what Senator Packwood put down as the choices, and again, I think all of us are free market people and believe the free market is the best mechanism. We have seen that time and time again, but I think that we were trying to respond to the two choices that we had, and I didn't get the impression that——

Senator **Bradley**. All right. That is what is known as the "Hobson's Choice."

Mr. **Smith**. Yes, sir.

Senator **Bradley**. I don't want to dwell on that. I just wanted to make the point that, for one, I don't see a difference between the energy industry and any other form of industry, nor do I see the need to subsidize one form of energy over any other form of energy if the objective is to back out foreign oil. Any source does that.

Mr. **Bryan**. I would agree.

Mr. **Smale**. We are not suggesting that. We agree with that.

Senator **Bradley**. You agree with that?

Mr. **Bryan**. Yes.

Senator **Bradley**. All right. As we try to think through this reform proposal, I think the key thing is to try to set some principles that we can agree to, and what I would like to do is mention a principle and then have each of you respond yes or no to that principle. Do you believe that any tax reform proposal should not increase the Federal deficit, which is the question that was asked earlier?

Mr. **Smith**. Yes, I agree with it.

Senator **Bradley**. Do you believe that any tax reform proposal should not increase the relative tax burden on middle- or low-income people?

Mr. **Smith**. To the extent that you are eliminating some of the tax preference items and putting more fairness in, there might be some mix in between, but on the overall, I would agree.

Senator **Bradley**. That is what I mean—overall. I mean that there won't be one person that will be paying more, but overall. If you took the category of income, you broke it down $15, $25, $30–40, 40–50, and so forth, that no low- or middle-income category would be paying a larger portion of the total tax burden than under current law.

Mr. **Bryan**. I am comfortable with that.

Mr. **Smale**. Yes, I am.

Senator **Bradley**. All right. Let me ask you this. Having looked at Treasury II—I don't know if you have had enough time—would you be paying more or less tax under Treasury II?

Mr. **Smith**. Senator, in the first year, we would be paying substantially more, even excluding the recapture.

Senator **Bradley**. All right.

Mr. **Smale**. The first year we would be paying more, and from the standpoint of cash flow, which is really the issue, as nearly as we can figure it will be 6 to 7 years before we would get even.

Mr. **Trautlein**. Because of our very heavy losses, we don't have that problem. We don't throw away the carryovers.

Mr. **Bryan**. Our company would pay increased taxes for the next 3 years.

Senator **Bradley**. This is really startling because this is a major role reversal for the American business community, and I frankly would like to probe this a little bit.

Mr. **Bryan**. If I might suggest, I think the business community is sort of tired of the current tax system. I think they are a little outdone with the tax shelters. They are really offended by what has been happening with regard to them. I think they are tired of running around having to pursue strategies within their businesses to hunt for ways to compete with their competitors and, at the same time, to save taxes. I am not proud of a low-tax rate.

Senator BRADLEY. Let me say I applaud your responses, and what I want to do is to get on the record a little bit more of your thinking so that other colleagues and people who are watching on C-SPAN can understand why. If you are paying more in tax under this proposal, why would you be for it—if you pay more in tax? I mean, the common assumption in America is—and in this committee and in the Congress—that if people would pay more, they are against any kind of tax reform. Why would you be for it?

Mr. SMITH. I think it is the price we have to pay for tax reform, and I think tax reform is long overdue, and we have an opportunity now. The timing seems to be there. I think the people across this land want tax reform, and I think it is a good thing to do.

Mr. SMALE. As I mentioned, it will be 6 to 7 years before we would get into a break-even situation. After that, we would be better off as a corporation, but that is a pretty long timeframe. And I think our basic feeling is that the system ought to be neutral. The system should not try to direct investments through the Tax Code. Let the marketplace do that.

Senator BRADLEY. And you are basically saying you think you are pretty good at what you do, and you will take your chances if everybody has got a level playing field?

Mr. SMALE. That is right. Our competition will take care of that.

Senator BRADLEY. Mr. Bryan.

Mr. BRYAN. As I say, I think our Tax Code today misserves the Nation in so many ways that we simply cannot let this chance get by to get it cleaned up, and I don't care what my tax people show me in terms of what it is going to cost our company. We are going to be for the tax reform.

Senator BRADLEY. Because you think it is basically good for the country?

Mr. BRYAN. Oh, I think it is essential for the country.

Senator BRADLEY. Would you talk a little bit more about that? Why?

Mr. BRYAN. We are sitting around with these high tax rates, encouraging people to do all kinds of irrational things—our most talented people sending their energy and resources after these tax schemes. We are not involved in business when we are trying to do that. Every time we try to make an acquisition, you have to go run to the tax department to find out how much the Government is going to pay for the acquisition, and we are tired of that.

Senator BRADLEY. You would have to find a new way to spend between October and January.

Mr. SMALE. What we might be able to do is to focus completely on running a business in a productive kind of a way.

Mr. TRAUTLEIN. Senator, may I just make a point, too? I think that, while we can make a theoretical argument that there should be no corporate tax at all, and of course that has been made, in truth of course the percentages of taxes paid by corporations has been going down and the percentage by individuals going up. That is a fairness issue, and I think we are not ready at this point to abolish taxation by corporations, so I think we are changing that mix to bring it back a little bit closer where it was earlier.

The **Chairman.** Senator Baucus.

Senator **Baucus.** Thank you, Mr. Chairman. Gentlemen, I think all of us believe in neutrality—as a goal to pursue. A number of observers commenting on this proposal have suggested that neutrality means one thing and would be good if we operated within the confines of the American borders. But we deal in the international marketplace. A lot of American observers—businessmen included—have suggested that because the world has changed dramatically in the last several years we have to look to see what other countries do, too. Neutrality and an even playing field as defined in this tax proposal might make sense within the borders of the United States, but to what degree do they make sense in the world community?

I would like to ask each of you if you think that this proposal would help, hurt, or have virtually no impact on the international competitiveness of American industry.

Mr. **Smith.** I think there are some provisions of it that concern us, and we have talked about the recapture, that could hurt us in terms of where we are competitive. And I think again we have to be awfully careful with the foreign tax credit provisions, not to upset those.

Senator **Baucus.** But on balance, for General Motors, does this help or hurt and why?

Mr. **Smith.** As I say, excluding the recapture, the costs of course aren't going to help us, but I think it is worth it, and we can survive that. The issues you have cited—the high dollar, the budget deficits, the trade deficits—really far outweigh the tax considerations right now.

Senator **Baucus.** So, you are saying essentially that this proposal does not have much effect on the international competitive position of American industry, as you see it?

Mr. **Smith.** That is right.

Senator **Baucus.** With respect to our competitive position, there are other factors that are more important: The value of the dollar, the budget deficit, maybe exchange rate volatility, productivity growth, and various other factors. Would the rest of you generally agree with that or disagree?

Mr. **Trautlein.** I made the point, before you arrived, and I think I've stressed international competitiveness throughout what I have said, that we have to look at the tax proposal in that framework, and I think it is all right as it is now balanced. In other words, you get about a tradeoff with a rate reduction and the investment tax credit, which is the thing, of course, that we have to look at. If we start tinkering with the rates—and in other words, the top rate isn't going to be 33 percent—then you have a horse of another color. So, we certainly—I couldn't agree with you more that we have to look at this in terms of the international situation, all of us.

Mr. **Smale.** As far as Procter & Gamble is concerned, it won't have any specific effect in relation to our international business. As a point of principle, as we have talked here earlier, it seems to me that if we have a trade problem caused by activities in foreign countries that we see as unfair, we need to address that in some way other than our Tax Code.

Senator **Baucus**. Why necessarily other than the tax law?

Mr. **Smale**. Because when we try to fix one problem—a steel industry problem or whatever it might be caused by international competitors—that Tax Code applies to all of U.S. business as well, and you get a totally, I think, unintended fallout as a result. It would seem to me that if in the Congress' deliberations and judgment that our trading partners are not being fair, then we ought to address that on a unilateral basis, and not try to do it with the Tax Code.

Senator **Baucus**. What if the foreign unfairness or the foreign competitive advantage is created by foreign tax law?

Mr. **Smale**. Then, my answer is that then is a subsidy, and then our Government has to decide and you fellows may have to decide to write new trade laws because if they have an advantage that we don't have, that has to be considered a subsidy and something on which we will apply our trade laws.

Mr. **Bryan**. It seems to me that it is an endless game, for us to try to fashion our tax laws to keep up with every country around the world. You can go to Hillside in Switzerland and get 10 percent. You can go to Hong Kong and get 15 percent. You go other places and get 50 percent, and we can't keep up with all of the incentives that can be put on other countries. It is a trade problem, not a tax problem, and the Tax Code is certainly not the way to solve trade problems.

Senator **Baucus**. Some American businessmen—tell me that the American business has about a 5-percent disadvantage in dealing with foreign competition because of the VAT that other countries use. Would you agree or disagree that the VAT system used in other countries—particularly because the tax on exports is rebatable—gives those countries, everything else being equal, an advantage?

Mr. **Bryan**. If you pull our rate down to 33 percent against many of the European countries that are higher than that—there are few at that level—then it will more than offset I am sure any VAT rebates.

Senator **Baucus**. So, you are saying that——

The **Chairman**. This is most interesting. This is the first time I have heard this. Pursue this, Max. I am curious.

Mr. **Bryan**. Most of the countries in Europe are at higher rates than we are. I mean, France is around 50. I think England is around 33 or something like that. They do refund VAT.

Senator **Baucus**. They do? That is the question.

Mr. **Bryan**. That is right. They do refund VAT. But if we have 33 and they are refunding VAT and they have a 50 rate, then it seems to me—but you can't keep up with all that. If we are going to try to do that, and I would be very suspicious of those who come in and specifically tell you exactly how much they are at a competitive disadvantage from a tax standpoint.

Senator **Baucus**. I haven't seen an analysis, but these are business roundtable companies that just tell me that it puts them at about a 5-percent disadvantage. However, you are saying that if the top rate is lowered to 33, it means you are paying 33 percent——

Mr. **Bryan**. It would be very difficult, I think, to find our business at a highly uncompetitive——

Senator **Baucus**. Now, what happens when we have a world where some industries have higher capital requirements than other industries? Some observers say that these industries, because they have very high capital requirements compared to some other industries—are having a tougher time in international competition and will have a even harder time facing their international competitors if this proposal goes into effect.

Mr. **Bryan**. The higher leverage in Japan.

Senator **Baucus**. That is correct. Do you agree or disagree with that?

Mr. **Bryan**. It seems to me that that is another unresolvable debate that one can go on and on as to whether or not they in fact do have high leverage in countries, because they have different accounting laws, different ways of constructing balance sheets. If there is a problem that you are convinced exists, then it seems to me the trade laws are the way to resolve it.

Senator **Baucus**. But if our corporate tax system were replaced with a VAT, would that be better or worse for American business?

Mr. **Bryan**. Much worse.

Senator **Baucus**. Much worse? Why is that?

Mr. **Bryan**. In my judgment. I think the VAT is a big old sales tax. I think it is regressive.

The **Chairman**. Did you preface it with repeal of the corporate profits tax and a replacement with that?

Senator **Baucus**. Yes.

Mr. **Bryan**. And I have never been able to understand how we can have no corporate tax and have an individual tax. There has got to be some relationship, it seems to me, between the two, or else all of us will incorporate, and we will have ourselves another tax shelter.

Senator **Baucus**. Do the rest of you agree or disagree? I would like the opinions of the rest of you on the VAT. Would it help or hurt? If you took the American corporate income tax, phased it out and replaced it with a VAT that yields the same revenue, would that help or hurt American business?

Mr. **Smith**. I would say basically I would not be in favor of that.

Senator **Baucus**. And why is that?

Mr. **Smith**. I don't think that you will get the result that you want with the VAT, and again, it turns out to be just an excise tax——

Senator **Baucus**. But some observers say it is more efficient, it is more neutral, and it gives American business the advantage of rebating a tax exports, which is legal under GATT.

Mr. **Smale**. I think it is a tax on consumption, which has some virtues in relation to taxes on savings. The experience that we have had operating in countries that have VAT do not suggest that there is an enormous difference in consumer performance between the United States and these other countries.

The **Chairman**. There is not a great difference between what—consumer performance?

Mr. SMALE. Yes. Buying patterns, consumptions.

The CHAIRMAN. You mean the VAT doesn't hurt the consumption?

Mr. SMALE. We can't measure any difference. That is right.

Mr. TRAUTLEIN. I am not saying it on a full tradeoff. What I have always worried about is that you will have both of them as you do in most of these foreign countries, and that what we will have is not having something that is revenue neutral. I would like to give some consideration to the complete substitution.

Senator BAUCUS. Just one more question. Some others have suggested VAT because they believe that United States institutions, including the tax system, tend to encourage too much consumption at the expense of savings. I am wondering whether you think we in the United States tend to draw the line too much in favor of consumption, at the expense of savings.

Mr. SMALE. I think in theory that is right, but I don't know if we had a VAT that you would see much change. I don't know that the countries that have VAT's have seen significant changes in saving rates.

Mr. TRAUTLEIN. Yes. I think that you have a whole cultural problem. You have a whole Social Security problem that interrelates on this kind of thing, and you can't address it just in terms of taxes, when there is a much larger cultural thing. Our whole culture as compared to that of the Japanese culture. Our whole Social Security system. And so, I think that is a real—question.

Mr. BRYAN. And I do think that the consumption problem is mostly related to having been accustomed to inflation, and the Tax Code is not a way of trying to redirect people's attitudes.

The CHAIRMAN. Thank you. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you. I want to welcome this panel of witnesses. Of course, Don Trautlein is a particularly valued constituent of mine, and he is also, as I am sure has been pointed out, chairman for now of the American Iron and Steel Institute, and speaks not only for himself on occasion but for that organization. I want to apologize for missing your opening remarks. I was in a hearing on financial services that started at 9 with Treasury Secretary Jim Baker. I can report to the committee that Secretary Baker is alive and well after his marathon session that he had with us on Tuesday.

Now, I understand that most of you—maybe not all of you—have expressed deep reservations in opposition to the windfall tax, the recapture on accelerated depreciation, and the mismatching of the elimination of deductions with the reduction of rates. Now, both of those provisions gain a fair amount of revenue, and I suppose that the reason the administration put those into Treasury II is that in accommodating other political concerns—the small business community by providing a graduated corporate rate, and so forth—that they came up short on revenue. I will be very candid. I don't like the windfall tax. I think it goes against everything this committee has ever stood for, namely opposing retroactivity.

When Secretary Baker was up here on Tuesday, I didn't think his defense that this was not retroactive was a very good one. If we want it to be retroactive, one of the things we would do is, in addition to putting the intangible drilling cost deduction into the minimum tax, which is what the Treasury proposed—since fair is only fair, we should go back and recapture on that. I didn't get a very good answer to that for some reasons but it is the same principle, and once we go down the road of becoming retroactive, I don't know where that really stops.

Nonetheless, we have the problem of coming up with the revenue. Any suggestions as to what we should do if we write the windfall tax provision out of tax reform?

Mr. **Trautlein**. I would say that there are several things. Of course, I am attracted, to the extent I understand it, by the business transfer tax—that is, the bill that Senator Roth has proposed, and you could change the timing of the phase-in and the phase-out of the provisions. The figures that I have seen show that this recapture over the 4-year period it would end up in 1989—would produce about $56 billion. I think both from an academic and a practical standpoint we all oppose it, and I think it really was an 11th-hour item that ought to be rejected and either change the phasing in and out or look for another source.

Mr. **Smale**. I suppose you could examine the preferences that continue in the administration's proposal, that is, continue to be in there.

Senator **Heinz**. Would you support, Mr. Smale, Don Trautlein's suggestion that we replace the revenues lost with a business transfer tax, which by the way doesn't have to be permanent—you could have a temporary business transfer tax. We have had a lot of temporary taxes.

The **Chairman**. Some of them started in World War II and they are still here.

Senator **Heinz**. Some started in 1933 or 1934, but believe it or not, we have had temporary taxes. How do you feel about that?

Mr. **Smale**. No, I would not support that, at least as I understand Senator Roth's bill.

Senator **Heinz**. Where would you get the revenue?

Mr. **Smale**. As I said, I think you can examine some of the preferences that continue to be in the administration's proposal.

Senator **Heinz**. Which ones do you have in mind?

Mr. **Smale**. Gas and oil. There are others. I think that we are best off as a nation when we have as few preferences as possible in the Tax Code, and there are still some in there. And I think that you can examine those.

Senator **Heinz**. Let me ask Roger Smith.

Mr. **Smith**. I support exactly what John is saying. To lose the fairness out of tax reform by this so-called windfall, and it certainly isn't, is just too big a price to pay, and there are certainly a lot of sources. You have mentioned them yourself. They could certainly be used to retain the fairness and at the same time raise the money. We have already said, Senator, that we understand that the revenue has to be raised. We support that, and we think we can get the tax reform and get the revenue and keep the fairness by broadening the base on some of these issues.

Senator **Heinz**. In theory, of course, that is absolutely right, but the reason I am asking all of you this question, and my time has expired and I will just finish up with a statement, and that is simply that—let me put it as childly as I can: You wouldn't be the first witnesses to come before us in all of this and say, listen, what they are doing to us is grievously wrong, it is unfair—and by the way, in this case I happen to agree, and you could easily pick up the revenue some place else. Gore somebody's ox—somebody else's ox—and don't gore ours, and the question is fine, we are willing to do that, but which ox do you want us to gore? And so far I have suffered from a lack of specificity.

Mr. **SMITH**. You don't have to gore anybody's ox in relation to anybody else. What we are just asking is to put the fairness back in. Certainly, if the administration says they can't live without the recapture, our position would be—the very things you are talking about—put all the tax preference items in there. Don't just pick on depreciation.

Senator **HEINZ**. Roger, we are all for fairness. The question is: Who else are we going to include?

Mr. **BRYAN**. May I suggest that Treasury I would be a good source: Move the depreciation schedules to reflect economic depreciation; take back some of the breaks for oil and gas, R&D, capital gains, etc.

Senator **BRADLEY**. And you would support those?

Mr. **BRYAN**. Yes.

Mr. **TRAUTLEIN**. I would not, certainly in terms of depreciation.

Senator **HEINZ**. I think you are going to get three other answers that are different from that.

Mr. **SMALE**. I would support Treasury I.

Senator **HEINZ**. You would? Would you support economic depreciation?

Mr. **BRYAN**. Closer than we are today with the proposal.

Senator **HEINZ**. Mr. Smale?

Mr. **SMALE**. Yes.

Senator **HEINZ**. Mr. Smith?

Mr. **SMITH**. I certainly don't think that we should do what he said about research and development. That is eating the seed corn, and I am not in favor of taking that course.

The **CHAIRMAN**. But isn't that an incentive that is not only a tax incentive but actually is not neutral?

Mr. **SMITH**. That is right.

The **CHAIRMAN**. But you would keep it, or would you get rid of it?

Mr. **SMITH**. I think again about what we said. There are some items in Treasury I that certainly would solve the revenue problem, but there are also some things in Treasury I that I think are better done in Treasury II. But again, I think the issue of the fairness is just what Senator Heinz said. You don't really have to gore anybody's ox if you do it evenly.

Senator **HEINZ**. My time has expired. Maybe we can continue this at another time.

The **CHAIRMAN**. I think we will. Let's just go on the research and development credit. It is a tax incentive, and it is not neutral. It is between different industries. Should we get rid of it?

Mr. **SMITH**. I think if all we had to do is put it on the current deduction basis, then I think we should be all right.

The **CHAIRMAN**. Can we go down the line on the R&D credit?

Mr. **SMALE**. If we are willing to get rid of every preference in that code for business, then I would get rid of it. If there is one thing that is going to—I would start there. If there is going to be one preference, I would start with research and development.

The **CHAIRMAN**. Do you mean that is the last one you would get rid of?

Mr. **SMALE**. That is the last one I would get rid of, but if we are going to get rid of all of them, then I would take that one with it.

The **CHAIRMAN**. Let me go back to Mr. Trautlein's business transfer tax, or Senator Roth's business transfer tax. And Senator Baucus was raising a question on the VAT.

For years and years, we have been hearing business indicate that we are taxing capital too heavy, or income too heavy, and consumption too little, and there is an honest debate as to whether we are, or if we are—if we move toward a consumption tax—is it regressive and unfair? But normally, business' position is that we should be moving—most business— toward some kind of a consumption tax. Whether that is an additional tax to make up the revenue we need, I am not going to argue here. Whether it is a substitute for some other tax that is in the bill, I am not here prepared to argue. If we get down to the end of this bill and we are $200 billion short and we are looking for revenue, and we have gotten rid of all the deductions we can get rid of, that may be some alternative we will consider, but would you address yourself to the concept of a business transfer tax or a value-added tax or a consumption tax and whether or not this committee should even be considering it or this country moving toward it or not. Let me start at the other end. We have been starting with Mr. Smith all the time.

Mr. **BRYAN**. I would definitely advise you not to do it. I don't think it is a good idea.

The **CHAIRMAN**. Don't worry about the politics of it at the moment. Just give us the merits of it.

Mr. **BRYAN**. No. The merits of it is, I think, that it is a sales tax. It is a sales tax on the goods and services. It is a regressive tax. It doesn't serve any purpose. I think a corporate tax can, with all of the preferences eliminated, be down at a nice low level and can raise adequate revenues along with the personal income tax.

The **CHAIRMAN**. Mr. Trautlein.

Mr. **TRAUTLEIN**. As I understand your question, you have done all you can and you are $200 billion short. And I think this Federal deficit is an extremely troublesome problem. We have to end up with a neutral package here, at a minimum. And in that case, I would support some sort of a consumption tax.

The **CHAIRMAN**. Mr. Smale.

Mr. **SMALE**. I think that the committee ought to study the issue of a consumption tax, which I think is really the question that you asked. I don't think that anybody is prepared at this point in time to say that we ought to go immediately to a consumption tax. But I do think it needs to be studied. I don't agree with Mr. Bryan that we ought to turn away from it in principle.

The **CHAIRMAN**. Mr. Smith.

Mr. **SMITH**. One thing hasn't been said that I think is terribly important, and that is if you go to a VAT tax or a consumption tax, you are going to have to have a brand new system here, probably the size of the Internal Revenue system, to collect the tax and to monitor it. And I am afraid that it will be more expensive and you will be losing revenue, and any small amount of tax that you can envisage, that you are putting a whole new system in.

The CHAIRMAN. Take another alternative then. You could go to an energy consumption tax—an energy excise tax—and you could make it neutral between the different forms of energy so it didn't favor one over the other, and you would have very few collection points in the country. It is a relatively simple tax to collect, and you have got between 4,000 and 5,000 total collection points in all. It will raise whatever amount of money you want to raise, and it is a form of a consumption tax. Presumably, everybody drives a car, heats their home, or in one way or another uses energy.

Mr. SMITH. Then you have gone away from your whole theory of fairness again, in picking on the energy users as opposed to the rest of them.

The CHAIRMAN. No, but everybody——

Mr. SMITH. Given that choice, I would rather see it applied overall.

The CHAIRMAN. Except that everybody uses energy, and I am not sure it picks on somebody.

Mr. SMITH. To some extent, but certainly in very different amounts. I think we are better off under the current system. What we see in foreign countries doesn't tell us that the VAT is the thing that America should go for right now.

The CHAIRMAN. Let me go now back to this incentive and neutrality idea. I asked earlier about the intangible drilling costs. There is another way we could do it in this country if you wanted to use the law because this country has enough natural resources. We could say that all energy used in this country must be produced domestically. We will import no oil, and we will phase out our contracts with Canada and Mexico on oil and gas. And we will deregulate all energy—oil prices, gas prices, or anything else—and there are enough coal reserves and oil shale in this country in tarsands to be energy independent without the use of the Tax Code. Would that be a wise policy?

Mr. SMITH. I think in Utopia it might, but I don't see how we would get there. I think we would all be dead before we got the coal things up to the speed that we need. I certainly think that we have been blessed by a great enormous coal reserve, but to suddenly mandate through a stiff tax or something that you are going to shift from no imported oil to the use of domestic fuel is going to be——

The CHAIRMAN. It wouldn't be a tax, other than you would have a tariff on imported energy so that they couldn't undercut your price. It wouldn't be a tax at all. I will give you an example—shipbuilding. We require all military ships to be built in this country. We don't require it of commercial ships. Therefore, we have no commercial shipbuilding in this country of any great note. If we were to do the same thing with military ships, my hunch is the Tridents would be built in Korea and our destroyers would be built in Japan, and Poland would be building a fair share of them. So, we just said we are going to buy America. It is not a tax bill. It is just a policy, but it is a use of the law to achieve a purpose which we think is a necessary purpose. Is that good or bad?

**Mr. Smith.** I think when we look around at other nations that operate on that theory, most of them are disasters, and I think we have got to be market-driven decision people here. The market works better than any of the so-called planned economies that we have seen. Now, at General Motors, we don't buy foreign steel. We do that as a policy, too.

**The Chairman.** Even if that meant that our military ships were all built overseas, because that is what the market would drive us to?

**Mr. Smith.** I don't think I can comment on the defense issues due to the secrecy that goes into the ships.

**Mr. Trautlein.** I think that everybody believes in fair trade—or free trade as long as it is fair—but you do have these offsets. There are national defense considerations in some of these industries, and I think that is one of the issues that you have to address here—the industrial base is being liquidated at a horrendous rate in this country. Now, the strong dollar at this stage is a major problem that we have, but I don't think we would want to find ourselves in a situation where we didn't have an energy industry in this country, or I hope a steel industry or whatever. If we ever had to fight another war and we didn't have it, we might as well not even start.

**The Chairman.** But that means we may have to undertake some measures that tilt against international market neutrality to achieve that.

**Mr. Trautlein.** Sure, but the question is whether we do it through the Tax Code or some other way, and that is the question you asked.

**Mr. Bryan.** And I agree. I think conceptually you are right, that there are means that can be used and laws that can be written to take care of problems such as that.

**The Chairman.** As I said, shipbuilding is an example. That is not the use of the Tax Code. That is a buy America act that says ships will be built in this country if they are military ships. They therefore cost us more money. I think the policy is a good policy. I don't want the Trident submarines made in Poland.

**Mr. Trautlein.** No. That is right.

**The Chairman.** Senator Bradley.

**Senator Bradley.** Thank you very much, Mr. Chairman.

I found the last line of questioning very productive in that it established clearly that there is a national security rationale for not allowing markets to function, whether those are domestic markets or international markets. I think, however, though that is a valid premise, that it is frequently taken to extreme, and you would be surprised what is a national security issue, not only in this country but around the world.

A couple of years ago, for example, the Swedes made the argument that they had to buy their shoes for their military from Swedish shoe manufacturers. That was a national security question. You know, this takes it a little bit to the extreme. Let's get back to the issue of the market and international competitiveness, because one of the central thrusts of the opponents of tax reform will be that this will kill our international competitiveness. And I have heard very clearly Mr. Smith in his testimony, and Mr. Bryan, and the others on this panel that what is hurting our competitiveness much more than the tax changes that might be proposed is the value of the dollar, first of all, and then the size of the budget deficit and the interest rate. Is that not correct?

Mr. **Smith**. That is correct.

Mr. **Trautlein**. I agree with that.

Senator **Bradley**. All of you agree with that. What about when the argument is made: What do we do about country *X* that subsidizes its industry through their Tax Code? Do you believe therefore that we should subsidize through our Tax Code? It seems to me that the sentiment of this group is that that is their problem.

Mr. **Trautlein**. No. I think it is our problem, but you can deal with it through the trade laws, but we have not had adequate trade laws nor have they been enforced.

Senator **Bradley**. That is not the point. We are not talking about the trade laws. We are talking about the tax laws, and I seem to hear you saying—and Mr. Smith made the point earlier directly—that if country *X* has got a big subsidy to industry *Y*, that is no reason for us to have a tax subsidy, that we happen to believe that we will take our chances competing with the country that uses various kinds of tax subsidies because our economy is dynamic, and the more market oriented it is, the more efficient it is. And in the long run, the better off we would be. Do you agree with that, Mr. Smith?

Mr. **Smith**. I certainly do.

Senator **Bradley**. Do you agree with that, Mr. Smale?

Mr. **Smale**. No, not entirely. I think that if there is an industry in the United States that is being influenced by what we, the Congress, determines as unfair activity on the part of a trading partner, then the Congress is obligated to deal with that through the trade laws, not through the tax laws.

Senator **Bradley**. Not through the tax laws. That is my only point.

Mr. **Trautlein**. Oh, I agree with you.

Senator **Bradley**. You agree then—not through the tax laws?

Mr. **Trautlein**. As long as you do something with the trade laws.

Senator **Bradley**. Not through the tax laws.

Mr. **Trautlein**. Right.

Senator **Bradley**. All right. That is fairly powerful testimony from rather diverse industries about a question that will be centrally debated on this committee. Let me ask you a specific question about the R&D tax credit, which you said that you would like to keep.

Would you rather have an R&D tax credit or lower rates? In other words, would you rather have the money to decide what you want to do with it—whether it is research or labor or capital—or would you rather have the IRS coming into your operation, as it inevitably will as these things begin to grow, and telling you after the fact that, gee, I don't know if that is an R&D expense, or this might be an R&D expense? Would you rather have a cleaner system with a lower rate, or would you rather have the IRS in your shop?

Mr. **Bryan**. I would strongly prefer the lower rate.

Senator **Bradley**. The lower rate?

Mr. **Bryan**. I would strongly prefer it.

Mr. **Trautlein**. I would, too.

Mr. **Smale**. I would agree with that, too. As I said earlier, I think the R&D credit is one of the most important in the preferences, but if you can get rid of all of them, that is the way I would do it.

Mr. **Smith**. The same here.

Senator **Bradley**. Is my time up?

The **Chairman**. No, keep going. You have another 5 seconds. [Laughter.]

Senator **Bradley**. With 5 seconds, let me get to the issue that is the most popular with this group, which is the recapture. It has been framed in this committee this morning in terms of revenue. The administration put the thing together at the last minute. They had a revenue shortfall, so they figured they would slap on the recapture, and raise $57 billion. And the issue is you made investments in certain kinds of capital assets. They have received a certain kind of depreciation, and so forth, and under the reform proposal, that generous depreciation is going to be grandfathered. You are going to continue to get that. At the same time, in order to make this salable, the rate has got to be dropped immediately. So, you are receiving a generous depreciation plus the lower rate.

Do you think we ought to do anything about that, or do we think we ought to just say that is the windfall that goes to those who invested in previous years? And I think that that is one of the things that the recapture is trying to get at, as well as the overall revenue.

Mr. **Trautlein**. Senator, those investment decisions were made based on the tax rate of those days. I think it is patently unfair to have a retroactive change affecting those investment decisions.

Senator **Bradley**. No, no. You are going to continue to get the depreciation.

Mr. **Trautlein**. You are going to get the difference, as I understand it——

Senator **Bradley**. Based upon what the rate would have been.

Mr. **Trautlein**. Yes, you are going back to straight-line depreciation, so I think you have changed the rules retroactively, and I think that is a very bad precedent to do in tax policy.

Senator **Bradley**. So, your position is full grandfathering, plus lower rate.

Mr. **Trautlein**. That is exactly right because you have an offset. There are other preferences. If you don't do that, then you change the whole capital recovery system in terms of the investment credit and everything else.

Senator **Bradley**. You would take an even less generous depreciation in the long term instead of the recapture?

Mr. **Trautlein**. No. I wouldn't say that. I just think that addressing the recapture provision is bad tax policy and it is a bad precedent.

Senator **Bradley**. Thank you.

The **Chairman**. Senator Baucus.

Senator **Baucus**. Thank you, Mr. Chairman. Mr. Bryan, you seem to argue in favor of simplicity. Do you find that this proposal is going to significantly simplify your company's operations?

Mr. **Bryan**. Significantly, yes, but not as much as Treasury I would have.

**Senator Baucus.** I asked the question because Secretary Baker said that among the three goals of economic growth, equity and simplicity—simplicity is at the bottom of the list. The primary goals of this proposal are equity and growth, I assume, and while simplicity is important, it is number three on the list. I am curious as to whether you find that practically your operations will be significantly more simple, at least from the tax standpoint.

**Mr. Bryan.** I think we would be making much less use of the tax department to tell us which way to go, this it would be simpler.

**Senator Baucus.** More use?

**Mr. Bryan.** Much less use.

**Senator Baucus.** How about the rest of you?

**Mr. Trautlein.** I don't think it is that much more simple. I think that we have plenty of room for tax lawyers and accountants, if this were passed the way it is. I don't see it that much simpler.

**Mr. Smale.** We see it that same way.

**Senator Baucus.** What about the comparative capital costs, either today or as a consequence of this bill? That is, how would the cost of capital in the U.S. compare to the foreign cost of capital both under present law as versus under this proposal? Is there any difference?

**Mr. Bryan.** The 10-percent dividend deductibility proposal is at least a step forward toward trying to reduce the cost of equity for which there is an enormous bias against in the United States and in the world today. And, I do think there are some cause for alarm about the erosion of equity bases in corporate America.

**Senator Baucus.** Have you had a chance yet to determine on balance whether you are better off or worse off from the standpoint of the comparative cost from a capital?

**Mr. Bryan.** I think that is very difficult to——

**Senator Baucus.** You don't know yet?

**Mr. Bryan.** It is arguable whether the cost of capital could be a little bit lower. Our book earnings will be somewhat higher and we do have the 10-percent deductibility——

**Mr. Trautlein.** Again, there are so many factors outside the Tax Code. There is the deficit which keeps the interest rates high, and——

**Senator Baucus.** I am trying just to focus on the effect of this proposal on one part of your international competitiveness: the cost of capital.

**Mr. Smale.** I think it ought to have a chance anyway to improve it. I think the lower rates do that, and as John pointed out, the dividend deductibility, if we can start in that direction.

**Mr. Smith.** I think that the dividend deduction is very important again in the shift from getting too much debt in the world right now as far as the U.S. corporations are concerned, but I think of course with the recapture provision, our cost of capital will go up.

**Senator Baucus.** On balance?

**Mr. Smith.** Yes.

**Senator Baucus.** So, you think, on balance, this proposal will increase your cost of capital?

**Mr. Smith.** Certainly until we get out of the recapture period.

**Senator Baucus.** So, once we get out of the recapture period, then you think that you are probably better off?

**Mr. Smith.** With the decrease in the rate, it should.

**Mr. Smale.** Yes. My answer was over the long term.

**Senator Baucus.** The long term, yes.

**Mr. Smale.** Yes. Certainly, in the initial period, this recapture will have a significant negative effect.

**Senator Baucus.** You all say that it is better not to accomplish social objectives through the Tax Code. Even if foreign countries' lower taxes give an advantage, that this country should not use the Tax Code because of all the costs associated with using the Tax Code to accomplish a certain objective. Is that correct? Am I paraphrasing that correctly?

**Mr. Bryan.** No. I said we didn't want to use the Tax Code to accomplish business objectives. Social objectives are a different matter.

**Senator Baucus.** Oh, that is something else. All right.

**Mr. Bryan.** Yes, and I repeat. As long as we have adequate trade laws that are effectively enforced, and that is a big if because they aren't adequate and they have not been aggressively enforced.

**Senator Baucus.** I asked the question in part because certainly the auto industry and the steel industry have benefitted from quotas which also have costs to society. I am curious as to why to such a great degree you oppose using the Tax Code to try to even out the world playing field and yet support quotas—and I know GM had a different point of view.

**Mr. Trautlein.** I would take exception to that. The steel industry has yet to benefit from any of these trade policies. Now, we hope that we will. They are now trying to put some arrangements in place, but imports are higher than they have ever been and the dumping margins are still there, and the subsidies are still there, even with the overvalued dollar. So, we hope we are going to benefit, because if we don't, we aren't going to be around; but people who think that these programs have been effective just aren't in the industry.

**Senator Baucus.** So, it is your view that quotas should never have been used?

**Mr. Trautlein.** No, that is not my view. My view is that the trade laws need to be enforced—When you have 55 countries coming in here with steel, and a lot more companies, and most of them or the vast majority of them are being subsidized and are dumping steel, something is wrong with our trade laws or their enforcement, if that can continue as it has. So, we are looking for the enforcement of those trade laws through the President's arrangement, but we have yet to see any substantial benefit. But I agree that we should address the problem through the trade laws and their enforcement. rather than the Tax Code.

**Senator Baucus.** Thank you.

The Chairman. Senator Heinz and then Senator Bentsen.

**Senator Heinz.** Thank you. Mr. Chairman, just to try and wrap up as briefly as possible on windfall and then go on to another issue. You have each testified against the windfall portion of Treasury II. If it remained in tax reform, which you say you all generally support, would you still support tax reform? Mr. Bryan?

**Mr. Bryan.** Yes.

**Senator Heinz.** Mr. Trautlein.

Mr. **Trautlein**. In our unique situation, probably yes, but I strongly advise against it.

Senator **Heinz**. Mr. Smale.

Mr. **Smale**. Yes.

Senator **Heinz**. Mr. Smith.

Mr. **Smith**. That is an awful price to pay for tax reform. I would hope that if it stayed in and you could say it is going to apply to everybody, then I would say my answer is yes. If it stays in in its current form, I don't know.

Senator **Heinz**. If we were to remove it, we have to find the revenue someplace. Should we look for the revenues on the corporate side or on the individual side? Let me take Mr. Smale since he hasn't had a chance to go first.

Mr. **Smale**. I would start with the preferences that are still in the administration's bill.

Senator **Heinz**. Corporate or individual?

Mr. **Smale**. Oh, I'm sorry. I am talking corporate.

Senator **Heinz**. Mr. Trautlein.

Mr. **Trautlein**. As I say, theoretically, I might not be for a corporate tax at all, but given where we are, I think we ought to look at the corporate side.

Mr. **Bryan**. The corporate side.

Mr. **Smith**. Yes.

Senator **Heinz**. I would like to change the subject. I think each of you probably said—although I wasn't here—that you felt tax reform was not only good policy and fair but it would be good for the economy. Is that right? Gentlemen, do you all believe that it is going to be good for the economy?

Apparently, we are going to be hearing from some economists later on who don't think it is going to be good for the economy. There is some concern that there will be less savings, that it will not reduce interest rates, but let me ask you. Why do each of you hopefully in 50 words or less think it is going to be good for the economy?

Mr. **Smale**. Because of a conviction that the free marketplace is the best way to direct the economy. I don't think any group of economists or, pardon me, Senators or business people are smart enough to do that, to mastermind that for this country. I think that the marketplace will do it.

Senator **Heinz**. Mr. Trautlein.

Mr. **Trautlein**. I think that, hopefully, I don't know—we almost seem to have a tax bill every year, and I think maybe if we felt that we had addressed this problem of fairness and simplicity and we got some rules that we can live with, that may encourage investment and encourage people to say that now we know what the rules are, we know what they are going to be. And that is why I am so strongly opposed to this windfall thing.

Senator **Heinz**. If you feel that way, there should be an amendment to this bill that would remove the jurisdiction of writing tax bills from both the Finance and Ways and Means Committees and both Houses of Congress for from 5 to 10 years. I think that is the only way you are going to change that objective, praiseworthy as it is. Mr. Bryan.

Mr. BRYAN. I think because it will be directing the energies of the people who are producing things instead of the nonproductive things that they have been directing them. By bringing the personal rates down to historic lows, or at least postwar historic lows and corporate rates, I think we will turn loose an enormous amount of economic activity.

Senator HEINZ. The criticism of economists is that this is going to reduce savings, the pool of savings. Maybe. Mr. Smith.

Mr. SMITH. You know, you can get economic arguments both ways on that, but again, I go back and say that the reduction in the rates together with the certainty now of the tax, at least for the near term, but you have to couple that with some resolution of the budget deficit and the trade deficit. I don't think you can look at just a tax bill in isolation. I think we have to make certain assumptions that we are going to handle the budget deficit and that we are going to get the trade and get the dollar back. If you see that, I think you would find the economists would say yes, this should help consumption.

Senator HEINZ. I think we would all like to handle the budget deficit by making assumptions about it. Unfortunately, we have to pass legislation, and we are having some difficulty with the House right now. I guess my last question. I apologize if someone has asked you this, but some people have said that if we do what is in Treasury II on the business side, on the corporate side, that it will encourage companies to move overseas more than to locate here, and I think for the purpose of Don Trautlein's oft-repeated complaint, I think we have to assume that we have kind of a steady state for the next 3½ years with respect to the enforcement of the trade laws. Ronald Reagan has been in office 4½ years, and I don't think his philosophy on trade, whatever it is, is going to change much. So, are we going to see people move overseas more than they are now if we make these changes?

Mr. SMITH. Certainly, not in our case.

Mr. SMALE. Not in our case.

Mr. TRAUTLEIN. I think again if you just try to isolate the Tax Code, it is probably pretty neutral there. The strong dollar is what is driving more people and more investment overseas than I think this change would.

Mr. BRYAN. I see no basis for that.

Senator HEINZ. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. I can understand why a man in the grocery business wouldn't see any basis for that.

Senator HEINZ. It is not a bad business either

Senator BENTSEN. Yes. Let me say first that I want to apologize, Mr. Chairman, for being late here, but I think maybe we have broken the impasse on the clean water legislation.

My concern is the question of competitiveness and what is being done to try to assist this country in that regard. Time and time again, we make decisions here without any thought of how it is going to affect us on trade for the competitiveness of our industry in this country. My concern is that that has happened here. I saw in 1981 a bill that was aimed at capital formation, and I guess most of you gentlemen supported that, but now we see a bill that puts another—I think the estimate is $123 billion—in the hands of the consumers. My guess is that when it comes to savings, they will save 6 percent of that. That is the traditional saving that we have seen in this country. I don't see the additional incentives in there for saving.

Then I look at the question of recapture. It seems to me that what happened on that one was that, at the last, Treasury realized they were at least $30 billion out of sync, and they needed some more money. And they reached up there and picked up $57 billion on recapture. Now, that is retroactive, if I ever saw a piece of legislation that is. I can understand the rationale; you have been taking deductions against a 46-percent tax rate, but you are going to recognize the related deferred income at a 33-percent tax rate. That might be a windfall. But if that rationale is true for ACRS, what about all the other items under sections 57 and 312—R&D, trademarks—you can go through a whole list.

So, I don't understand that. And it seems to me, once again, that we are not addressing competitiveness. What we want to do is modernize the productive capacity of this country. I am concerned about the erosion of the manufacturing base in this country, and I think that it is terribly important that we not see that happen. Do you gentlemen really believe that we are going to be more competitive in this country by this approach? Do you believe that industry will be encouraged more than under present law to modernize its productive capacity? Explain that one to me.

Mr. **Trautlein**. No, I don't believe that, and I said in my testimony and then in my statement that at best you would see maybe a tradeoff if the rates do go down to 33 percent with the repeal of the investment tax credit. And it looks like CCRS and ACRS are about the same.

As I have said all the way through, we have got to be concerned about tax laws that are competitive in the international arena, and if we are not, then we have to address our trade laws so that people who do have better capital recovery, that then becomes a subsidy and it is something that we can levy tariffs and duties against because there are only two ways to do it. One is to be competitive in your tax laws and the other thing is to pass new trade laws and enforce them aggressively to say that that is a subsidy.

Senator **Bentsen**. Let me make one more point. Mr. Smale, you were talking about enforcing trade laws. We have not had an administration, Democratic or Republican, that has had a trade policy in this country, a coordinated trade policy. Section 301 is there, and you just don't see it used. We have seen the President use it once when we forced him to on the Canadian case on the investments there and its discrimination against us. and we won when we did that.

But we are up against competitors today that that is their No. 1 priority for their country. You hear this country of ours moving from a creditor nation to a debtor nation for the first time in 72 years. We are going to be owing more than Mexico and Brazil put together, and finally, you will be able to add Poland and all the rest of them, unless we can turn this thing around. And that is what is concerning me in the tax bill—how this country remains competitive. It is not just in the tax structure. As some of you have said, it is in our fiscal policy and trying to get this deficit down. It is in a whole range of things, but in each of these instances, we must address trade in our decisions.

AT&T is deregulated in this country. We gave no thought to what was going to happen to us insofar as our competition moving in here and replacing General Electric—not General Electric, Western Electric. But when you watch Japan privatize Nippon Telephone & Telegraph, they gave a great deal of consideration as to how it was going to open up that market to trade. I see my time is up

The CHAIRMAN. Let me just pick up on a question—or an answer Mr. Bryan gave. You said no, I don't want to use the tax incentives for business decisions, but it is OK for social decisions or social policy or something like that. Can you elaborate on that?

Mr. BRYAN. I think that there are certain social goals that are worthy. I think the graduated income tax rates is one. The personal exemption, mortgage interest, charitable deductions are all very worthy, and I don't think it would be consistent to say that the Tax Code should not respond to any interest, but I think it should not respond to special interest of business. That is my point of view.

The CHAIRMAN. Let me ask you a specific question involving health insurance because it is a debate that goes on perpetually within the committee and between the House and the Senate and the administrations. I would contend—and I practiced labor law for a number of years and was representing employers—I was perfectly aware that a business agent in negotiating in those days would rather have $50 in health insurance than $50 in wages because the $50 in health insurance wasn't taxable. And because of that long-standing policy, health insurance is now so prevalently provided by employers that you really have no demand in this country from the general populus for national health insurance.

Mr. BRYAN. Right.

The CHAIRMAN. I think probably had we not had that policy, we would today probably have something like the British National Health Service or the variety of the quasi socialized health systems in Europe. But the key was that it was not taxable as income, and that is why the business agents negotiated—Mr. Smith's industry was one of the first ones to do so. Is that a policy that should be now rejected or turned around? That is a clear use of the Tax Code. In this case, it is simply a forgiveness of tax on what would otherwise be considered income.

Mr. BRYAN. It is a clear use of the Tax Code to serve a special business interest.

The CHAIRMAN. No, that is not a business interest. That is a social interest. We think people ought to have health coverage, and we decided to encourage employers to do it by not taxing it as income to the employee, rather than whatever other method we might have gotten.

And two other methods we have gotten are Medicare and Medicaid, and I think they are good comparisons as to which is a better delivery of health in this country. The way the employers currently deliver it—contracting with Etna or Blue Cross or Continental, or whoever you contract with, or in some cases, health organizations——

Mr. **Bryan**. Or privately.

The **Chairman**. Or private, or to have the Government more or less—at least tax you—take the money and pay it out and provide it much in the way we do with Medicare and Medicaid.

Mr. **Bryan**. I guess I am not sure that people would not be providing them if they were taxable to the employee.

The **Chairman**. They haven't in other Western industrialized countries, and whether we would be different or not, I don't know, but it certainly has not been the pattern in other countries. You end up with the Government providing it. I am curious. I would like to go down the line. This is the last question I have which is whether those kinds of tax decisions should also be neutral and we ought to tax health insurance and day care and other social benefits that employers provide.

Mr. **Trautlein**. Theoretically, if you wanted to get a minimum tax rate, that is what you would do, but I don't think from a social standpoint, given where you are, you can get there from here. On some of these social things, we saw what happened on contributions as well as health insurance, and we may be able to take, as Treasury I tried to do in contributions, and as Treasury II does do in the case of medical costs—take a little piece of it. But I don't think—you know, I think you would have a revolution if you tried to change all existing labor agreements that really do take into account the economic costs and benefits to the employees of these benefits. So, I don't think we can radically change it.

The **Chairman**. Mr. Smale.

Mr. **Smale**. I agree with that. I think you can argue the theory, but I think in practice it would be very difficult to turn away totally from the existing structure.

The **Chairman**. Mr. Smith.

Mr. **Smith**. I think, even beyond that, when you look at the health care in other countries compared to what we have here, I think it shows that our system certainly has a better track record—for whatever purpose you want to say—that certainly the health care that you get under our current system is being delivered more effectively.

The **Chairman**. Gentlemen, I have no more questions. Senator Bradley?

Senator **Bradley**. No questions, Mr. Chairman.

The **Chairman**. Senator Baucus.

Senator **Baucus**. To what degree do you think tax laws encourage major American businesses to merge or to acquire other companies today? I come from the State of Montana. ARCO bought Anaconda Copper, for example. There is a lot of talk that our present tax law is a great incentive for mergers today. I am curious as to the degree to which you gentlemen think that is true.

Mr. **Bryan**. I think it is very significant. Tax laws carryforwards are the real reason for a lot of mergers to take place and stepping up depreciation when assets are acquired can often pay substantially for acquisitions that are made. And there are other kinds of tax motivations that exist in merger activities.

Senator **Baucus**. Do you think it is proper for the Tax Code to encourage those kinds of mergers?

Mr. **Bryan**. I think that they are doing it. I think that those particular features, the high depreciation, can be stepped up for that purpose. It certainly motivates it. I don't know that I have the time to comment on whether mergers are good and bad in America in our time.

Senator **Baucus**. Do any of the rest of you have a comment on that? The degree to which our present code encourages mergers.

Mr. **Smith**. I can assure you the Tax Code had nothing whatsoever to do with our mergers.

Senator **Baucus**. Do you think that is true for most acquisitions?

Mr. **Smith**. I believe so. I think they are done mostly for business reasons. I see very, very few done for tax reasons.

Senator **Baucus**. Do you think that this proposal before us will discourage mergers or have virtually no effect?

Mr. **Smith**. I can't say that it would have much effect.

Senator **Baucus**. Do you think that some of the mergers that have occurred have diverted executives' time and energy away from producing the better product and more toward rearranging the financial statements or not?

Mr. **Smith**. No, I don't. I think most of the mergers that I see are made to improve the business conditions of the corporation.

Mr. **Bryan**. I think that is an unresolvable debate. I really do.

Senator **Baucus**. It is not going to be resolved here today. I know that. [Laughter.]

Do you think that in America there are too many institutional pressures for focusing or the short term?

Mr. **Smith**. I don't think so. I think that most of us are trying to create a future instead of backing into it, and I think long-term planning in this country has increased phenomenally in the last 10 years.

Mr. **Smale**. I think those pressures exist, but I don't know what you would do about them, except ignore them. You would run the business the way you have to run the business for its own sake in the long term.

Mr. **Trautlein**. I would agree there are many, but when you say too many—we live in this society and that is what it is, and I don't think there is much we can do about it.

Senator **Baucus**. So, you don't worry about it?

Mr. **Bryan**. Yes.

Mr. **Trautlein**. We worry about it, but I don't think we are going to change it very radically.

Senator **Baucus**. The fact that you worry about it, to me, implies that perhaps we should try to do something about it. We shouldn't make mistakes as we move in that direction, but we should still try to do something about it. I am curious as to whether you think the present Tax Code unnecessarily encourages short-term considerations and, if so, whether you think this proposal would have any effect on that.

Mr. **Trautlein**. You know, Senator Long started off by referring to a previous career of mine, and I remember a great dean in the accounting profession say that reporting on as short a period as 1 year would be indefensible if it wasn't indispensable. So, we are in an American society, and people want to know shortrun results, and we have to report quarterly. The Congress has required that of companies that are publicly traded, and I think that is our culture, and I don't know that we are going to radically change it.

Senator **Baucus**. Why has the rate of growth of productivity in America fallen dramatically behind that of other countries such as Germany, UK, and Japan? What has caused that?

Mr. **Trautlein**. I think that is a very complex thing, too. I think part of it was our investment. Part of it was our management. Part of it was labor. I think we have been addressing those problems certainly in the troubled industries very dramatically in the last 2 or 3 years, but I think it is a combination of things where others had industrial policies perhaps that were directed to investment. Maybe the managers in those days did a better job working with labor, and there are problems of that sort that we have been addressing——

Mr. **Smale**. I think we have to be careful not to overgeneralize about productivity. Certain elements of the American economy have been very productive.

Senator **Baucus**. Oh, that is true. In Japan as well there are winners and there are dogs, so the average is pulled down because of, for example, the very low productivity growth in agriculture.

Mr. **Smale**. That is true.

Senator **Baucus**. I have this haunting, nagging feeling, however, not only as we consider this tax proposal, but more importantly as we look at other indicators—the budget deficit, the trade deficit, the overvalued dollar and our savings rate—that we should be spending more of our time addressing the core questions of productivity and growth and competitiveness, rather than, at least in tax area, rearranging the deck chairs on the ship.

I hope that all of you continue to address those basic questions. Thank you.

The **Chairman**. I know that Senator Heinz has a question. Senator Bentsen does, and Senator Wallop hasn't had a chance to ask. For the benefit of the next panel, we will run back to back with this panel and go right through the lunch hour if necessary. I don't want to break and come back after lunch. Senator Heinz?

Senator **Heinz**. Mr. Chairman, yes. Picking up on something Don Trautlein said, let's assume we pass Treasury II. Hopefully, we find a way of solving the windfall problem. Can you be sure that the American business community won't, as it came at us in the late 1970's and early 1980's, with some success, be back at us with some kind of request to improve the treatment of capital assets, even if inflation takes off again?

Mr. **Trautlein**. No, I don't think you can because, if we don't address these other problems we have been talking about, if we don't address the Federal deficit, the overvalued dollar, and trade laws, we will be back because you have to look at everything. And when you are looking at survival, you don't ignore anything. I think that addressing these other basic problems and getting a level playing field there, then I think it is reasonable to say that we might not be back.

Senator **Heinz**. Mr. Smale.

Mr. **Smale**. I think in the narrower context that I interpreted your question, I would hope that there would be some assurance that the business community would not be back. The point has been made here this morning, and I think properly, that we really would like to get a Tax Code that stays in place and doesn't change for a period of time.

Senator **Heinz**. I want to make it clear that what I am asking has to do with the provisions that affect capital assets—things like capital tax credits, the ACRS, the new cost recovery system. I just wanted to get very clear that if we assume, to make it easier for you to answer the question, that we find a way to take care of the windfall provision, that in taking care of it, we don't change what Treasury II has proposed on their cost recovery system. Can we be sure that General Motors or other people aren't going to be back here 2 or 3 or 4 years from now, saying my goodness, those provisions you gave us on capital assets just were, you know, we have got to change them. Mr. Smith.

Mr. **Smith**. I don't know that I can answer that without knowing all the other circumstances. If you assume a continuation of the current economic climate and that we can solve all the budget deficits and trade deficits, I don't see anything that says we should come back.

Senator **Heinz**. Who is saying we can solve the budget deficit?

Mr. **Smith**. I think it has to be done right down here in Congress.

Senator **Heinz**. We know that, but is there someone saying we can solve it?

Mr. **Smith**. I certainly hope so.

Senator **Heinz**. There are no volunteers.

Mr. **Trautlein**. I certainly think that you can't ignore it, and I think the other thing is: No one knows how this is going to play out.

Senator **Heinz**. All right. I think I have my answer, such as it was. I can't resist asking this last question. I apologize to the chairman. I must have lied to you, but I didn't intend to lie to you. You know, all of you are for retaining the foreign tax credit so you don't pay taxes twice overseas. You are all for retaining the deduction for businesses—corporations—for State and local taxes. Right?

Mr. **Bryan**. Yes.

Mr. **Trautlein**. Yes.

Senator **Heinz**. Now, the biggest single item we are going to have in contention in this committee, I suspect, is the deductibility for individuals of State and local taxes, and you know, in a sense, you are off the hook. You get to keep your deductions there. Why should we treat businesses differently than individuals? Mr. Bryan.

Mr. **Bryan**. It is a genuine cost of doing business.

Senator **Heinz**. It is a cost of paying taxes, too.

Mr. **Bryan**. I think it is a highly debatable issue as to whether taxes should be deductible for individuals, and I don't have a point of view on that, but I do feel very strongly that business deductions such as this, or taxes such as this should be deductible.

Senator **Heinz**. Mr. Trautlein.

Mr. **Trautlein**. I agree generally with Mr. Bryan, but you know, we have the same issue on self-employed and on Social Security. You pay that as a tax. Or even people that are employed, whatever we pay there, we get taxed on that, an income tax. So, it is an extension of that, but I certainly agree that it ought to be deductible for businesses.

Senator **Heinz**. Mr. Smale.

Mr. **Smale**. I do, too. It is a cost.

Senator **Heinz**. You think we should treat businesses differently than individuals?

Mr. **Smale**. Yes, absolutely.

Mr. **Smith**. I think you get the whole issue of resolving— What you end up with is a tax, and what particular items you put in and what particular items you put out is something the committee has to sort out, but certainly from a business point of view, it is a cost of doing business. Now, I agree with you. From the personal point of view, it is also a tax on a tax if you don't allow the deductibility.

Senator **Heinz**. Thank you, Mr. Chairman.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. Just one question, Mr. Chairman, because of the lateness of the hour. Mr. Smith, you were speaking earlier of the importance of the deductibility of dividends and the 10 percent dividend paid deductions. In all candor, Mr. Smith, I think at 10 percent it becomes partially symbolic. It does not have a great deal of influence, but it still costs $5 billion. So, I would say to you that that is going to be very much at risk in this bill.

I had another proposal made to me yesterday which intrigued me, and I would like to get the reaction of any one of you if you have some strong feelings about it. The proposal was not to use that approach but to permit full deductibility of any dividend on any net equity increase.

Mr. **Bryan**. I like that.

Senator **Bentsen**. Now, that would be much less in the beginning. Now, if it works, it would finally be a great deal more, but only if it works.

Mr. **Trautlein**. Does that include retained earnings?

Senator **Bentsen**. No, that would be net equity increase raising new——

Mr. **Bryan**. New issue——

Senator **Bentsen**. New issue net equity increase. Any reactions from the others?

Mr. **Bryan**. I said I would react positively to that, because I think it would encourage the issuance of new equity, and we would have a larger equity base in America, and I am very concerned about that.

Senator **Bentsen**. That is right.

Mr. **Smith**. And I think we would have to look very carefully at that. You might end up with people raising equity that they don't need in their business to obtain the deductibility, and I think that could be counterproductive.

Mr. **Smale**. We would have to look at it.

Senator **Bentsen**. Yes, I asked that same question, and I also was concerned some about the complexity. And you want to be darned sure you don't end up in a churning situation, but it is still an intriguing idea. As you say, I think we have to think it through, but some of you might have had a strong reaction.

Mr. **Smith**. I do agree with you that it is a small deduction, but I think a principle that we would establish by including some provision in the bill for that is important because there is not enough equity right now, and that is directly the result of the tax treatment of interest being deductible and dividends not.

Senator **Bentsen**. The problem you have is that you have so much principal involved—spelled with an AL—that the other may go. [Laughter.]

The **Chairman**. Senator Wallop.

Senator **Wallop**. Thank you, Mr. Chairman. I would say to my friend, Max, that I think American productivity has far exceeded that of Europe. And I would also suggest to you that there is something we could do about mergers and everything else. We could do what France has done and basically nationalize the top 25 industries in the country and lose $28 billion a year and create no new jobs.

For all the problems that may be out there in one way or another, the strength of the American economic system has been clearly demonstrated over the last decade and a half, as opposed to the last decade and a half in Europe. But I am going to pursue another little area because in each of the statements that you made there are words to the effect that the proposal will stimulate the economy, yet with revenue neutrality it is difficult for me to see how rearranging the tax obligations of different Americans is going to do much economic stimulation. Then, as I understood it, you each said that for 3 years, broadly speaking, your taxes would go up and then they would go down, but in response to Senator Heinz' question, the forecast of Chase Econometrics is that economists can't see that clearly.

How can you all see 3 years and the Econometric people not see 2 years? And what provisions are going to stimulate the economy? I just toss that out for a volunteer.

Mr. **Smith**. I think a lot of it is based on our vision of redistributing some of the taxes and some of this business of getting rid of some of these tax shelters that we think have gone into uneconomic measures. I believe there are buildings being built today that shouldn't be built, and I think if we can redirect some of that and get the fairness issue back in, we believe that a healthier economic climate will exist.

Senator **Wallop**. You think it goes close enough to doing that?

Mr. **Smith**. Pardon?

Senator **Wallop**. Do you think it goes anything like close enough to accomplishing that? It strikes me, as I read it, there really is precious little reform in this thing, nothing like what I would have hoped that we would see, and nothing like enough for me to call it reform. I just think it is a new tax proposal.

Mr. **Smith**. There are certainly degrees. I will admit that, yes, sir.

Mr. **Smale**. I think our belief that the proposal will produce a stronger economy is really based on the conviction that a free market is a better director of where capital goes than is a tax code.

Senator **Wallop**. I couldn't agree more, but Mr. Smale, where does the free market get created in here?

Mr. **Smale**. I'm sorry?

Senator **Wallop**. Where does the free market get created in here? I understand what you are saying. I just can't find it.

Mr. **Smale**. OK. I guess I see this as a greater deal of reform than you do, that is, that the absence of many of the preferences that have been in the Tax Code before. Now, there are still preferences in it, but it seems to me that it is a tax code that is more responsive, at least, in the direction of the free market than the current Tax Code. And on that basis, I think the economy will be better off.

Senator **Wallop**. But aren't they really trading what amounts to a hoped-for lower interest and increased consumption for growth? I mean, there doesn't seem to be any growth orientation in this. And that is why I am trying to find from you where you suspect that this economic stimulation is going. And in other more specific terms than fairness and justice.

Mr. **Smale**. If you believe the free marketplace is a better director and the free marketplace is going to have more to say under the proposal than it does now in the Tax Code, then I think it is a fair assumption that the economy will be stronger.

Senator **Wallop**. I agree with that, but I guess I am obviously not going to get there in 5 minutes. It is one thing to say it takes place. I am asking if there is anything specific in there that you think advances the free market, which I don't think it does.

Mr. **Bryan**. Yes, I do. I think that the marginal rates at 33 percent for corporations and 35 percent for individuals, as I said earlier, are historic lows and are powerful motivators. People are going to stimulate activity, and instead of going off building those apartments that Roger talked about that we don't need, they are going to be doing things because they can keep that money.

Senator **Wallop**. Except that as you examine it, it doesn't achieve what it says it does. In point of fact, a goodly proportion by Treasury's own tables of middle class, especially upper middle class, will be paying a greater load of taxes, not lesser.

Mr. **Bryan**. They don't pay more taxes, I don't think, sir.

Senator **Wallop**. Treasury's tables suggest that they do. My time is up. Thank you, Mr. Chairman.

The **Chairman**. Senator Symms.

Senator **Symms**. Thank you, Mr. Chairman, and gentlemen. I apologize for not being here when you made your statements, but I do have one question I would like to address to each of you, and that is on the subject of the losing of deductions if this bill passes, pretty much in place, on January 1. And the rates come down on July 1.

Now, if you take this back to what happened in 1981, there is a lot of evidence that points to the fact that, by delaying reducing the rates, people kept delaying economic decisions until they could get to lower rates in the next year, in the next period, and it contributed to the recession in 1982. And I have talked to some economists who tell me that if this passes as perceived by Treasury that you can be guaranteed a recession in 1986 while people are waiting for the lower tax rates to take place. You are going to lose the deductions on July 1, but then they will wait until January 1 to start making the economic decisions that is perceived will happen with lower tax rates.

Now, I just wonder if your economists are telling you, or if you don't have an answer now, I would like to have you have them look at it from that perspective because I think it would be tragic to—I mean, I think there is a tax on decision making right now because of all the uncertainty that was created by the Treasury's proposal on Treasury I, and then now all the talk on Treasury II, people are simply not making decisions based on their wondering what is out there in the future. But the longer we put off lowering the rates, if we are going to do it, it seems to me like it is setting up an unnecessary down push on the economy. I just want to start down the list. Mr. Smith, do you have any comment on that?

Mr. SMITH. I haven't asked our economists, and I will. I think that for our own industry, much of our spending and much of our decisions are driven by our long-range plans, and while taxes have an impact on them, they aren't the deciding factor.

Senator SYMMS. So, you don't think it would have any impact?

Mr. SMITH. I don't want to say any, in fact, because I don't know that I can see that out that far, but certainly, as I say, our capital spending and items like that are being driven by Government regulations that we have to meet, market conditions where we have to have product changes, by new technology—factors other than the Tax Code.

Senator SYMMS. Mr. Smale.

Mr. SMALE. That is basically right, Senator. Again, we will talk—I will talk with our economists. I think that, in theory, there is something to what you are saying. Uncertainty can produce different kinds of results. As far as we are concerned, I don't see that.

Senator SYMMS. You don't perceive this will help stimulate a recession in 1986?

Mr. SMALE. Again, as I said, I do want to talk to our economists. I am really talking from the standpoint of our own business decisions, and as Roger Smith said, we are not going to be making different decisions as a result of the mismatch between the phasein of the lower rates. We would wish that they would come in together.

Mr. TRAUTLEIN. In our case, having a net loss carryover and that sort of thing, I don't think it would have any effect at all on us specifically. We are more concerned about the transition rules because if they aren't right, they could have a great effect on us, but this isn't the place to get into that.

Mr. BRYAN. I would agree with what has been said.

Senator SYMMS. All right. Thank you, Mr. Chairman.

The CHAIRMAN. Are there any other questions of this panel?

Senator WALLOP. Mr. Chairman, I just have an observation because I had thought Senator Heinz had put the figures that I was referring to onto the record, but basically, what Chase Econometrics has said is that in their opinion, over the next 2 years, the Reagan tax reform plan would slash capital investment by $48 billion, boost consumption by $8 billion, which is the stimulation we have been talking about, lower interest rates by one percentage point, and cut the GNP by $25 billion.

Now, I guess that is what I was referring to and wondering where in this we were going to get the kind of stimulation we were talking about and also the observation that I made that really what it appeared to be was that we were trading a decrease in productivity for an increase in consumption and lower interest rates and that I don't think that is kind of what we have in mind or even the President has in mind to accomplish with this proposal, if it is going to do that.

The **CHAIRMAN.** We are going to have data resources and any number of others testify before we are done. This is just the start of a long, long train of hearings. Gentlemen, thank you very much. Oh, excuse me.

Senator **BAUCUS.** Mr. Chairman, I don't mean to belabor a point but Senator Wallop and I were talking about productivity in America. Let me give the committee the figures for manufacturing productivity measured in constant 1983 dollars. In the period from 1977 to 1982, U.S. average annual rate of productivity growth was .06 percent. In Germany it was 2 percent, France 3 percent, Italy 3.6, Japan 3.4, and U.K. 2.7. For 1983 alone—this is again manufacturing productivity, the output of manhour of work. In constant 1983 dollars—4.2 percent. Germany is 4.6, France 6.1, Japan 6.2, and the United Kingdom 6.1. Just in the United States the rate has been falling over time. The point I am making is the trends are going the wrong direction for us, in the rate of growth of productivity.

Senator **WALLOP.** I hope you wouldn't trade their trends for ours because they haven't created a job in the last decade in all of Europe. They may be working harder with those——

The **CHAIRMAN.** Gentlemen, I will put the two of you on as witnesses after we finish the next panel. It has been a most instructive morning. I appreciate very, very much your taking the time, gentlemen. Thank you.

Mr. **BRYAN.** Thank you.

Mr. **TRAUTLEIN.** Thank you very much.

The **CHAIRMAN.** Next, we will have a panel consisting of John Richman, the chairman and CEO of Dart & Kraft, William Berry, the chairman and CEO of Dominion Resources, and Philip Smith, the president and chief operating officer of General Foods Corp. Could I ask those who are leaving the room if they could hurry their exit so that we can quiet down and start on with the next panel which has been very, very patient and tolerant in waiting. Gentlemen, unless you have any objection, we will go in the order that you appear on the panel, with Mr. Richman first, and then Mr. Berry, and then Mr. Smith.

Mr. Richman.

## STATEMENT OF JOHN M. RICHMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, DART & KRAFT, NORTHBROOK, IL

Mr. **RICHMAN.** Thank you, Mr. Chairman. My name is John Richman, and I am chairman of the board and chief executive officer of Dart & Kraft. We have submitted a prepared statement. It tells you who we are. We are a large food and consumer products company, with some mix of relatively heavy industry in there, and it also describes our position. Let me just take a couple minutes here to summarize it, and then, later on, of course, I will be delighted to answer questions.

We have had a debate for a number of years in this country about whether we need a national industrial policy. I have always felt we have one, and it is in the Tax Code. It is a policy which favors one coroporate taxpayer over another. Some of us who make money and pay taxes and pay dividends kind of feel as if we have been the only corporate taxpayers out there for some time, and this is just plain unfair, I think, and results in a misallocation of investment and a misallocation of resources. The present Tax Code also favors one kind of industry over another. It favors capital-intensive industries over labor-intensive. It favors machines over people, if you will. You can depreciate machines, but I guess, unless you are a professional baseball team, you can't depreciate people. It favors one form of investment over another. There is a bias against savings.

Reference has been made on a number of occasions to erosion of the equity base. The equity base in this country is eroding. Corporations, on one hand, are making acquisitions, borrowing to make acquisitions, enabled to do it because of interest deductibility, and on the other hand, they are repurchasing a large portion of their own equity. I think these motivations derive directly from the Tax Code, and I think this favoring of investment leads to increasing vulnerability in the economy, in terms of the high debt load that is carried by a great number of industries and their vulnerability, particularly in times of a downturn in the economic cycle.

Finally, I think the industrial policy, if you will, encourages avoidance of taxes by us and others. I mean by that that we are all in a sense forced by the competitive system to allocate part of our resources to investments which are really out of our line of business.

For example we have a leasing company that owns parts of 747's and power-generating plants and other unrelated assets. That is not our business. We are doing it to help bring ourselves back into the ballpark in terms of the taxes we pay, and I can't believe that is desirable public policy. As far as I am concerned, the President's proposal in large part—not completely—is responsive to these deficiencies. It broadens the base so that a larger number of taxpayers are contributing. You have something more equivalent to that level playing field everybody talks about Similarly situated taxpayers would pay more or less similar taxes on their earnings. The elimination of the investment tax credit and the moderation of depreciation restores more balance as between different types of businesses. I think the dividend deduction is a small but significant first step in restoring parity, and there is less encouragement to avoid paying taxes because a lot of special preferences are eliminated. The result is more neutrality in business decisions, fewer decisions made for tax reasons and more decisions made for business reasons.

One last point I would like to make. There are imperfections in this bill. Some of them have been discussed this morning. We may talk about some of them during the question period. For example, the recapture provision is a disturbing one, particularly because of its retroactivity and what it may presage for the future. The dividend deduction is a very low one. Some of the employee benefits provisions should be examined further, I think.

So, the proposal can be improved, but I would like to make one thing clear now so that, when we talk about all of the things that are wrong with the bill, I for one, anyway, won't be misunderstood.

I think the President's proposal represents a massive step forward in the right direction, and if I were to be asked whether to take what is in that proposal right now as opposed to the present Tax Code, there would be no choice as far as I am concerned. I would take the proposal in a minute.

The **Chairman**. Thank you. Mr. Berry.

[The prepared written statement of Mr. Richman follows:]

# STATEMENT OF

JOHN M. RICHMAN

CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER

DART & KRAFT, INC.

ON

# TAX REFORM

BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

JUNE 13, 1985

Mr. Chairman and members of the Committee on Finance, my name is John Richman. I am Chairman of the Board and Chief Executive Officer of Dart & Kraft, Inc. Before I begin, I would like to thank you for inviting me to share my views on the shortcomings of our current tax system and the urgent need for tax reform. I applaud the President for his historic and courageous proposal for comprehensive tax reform, and the generally warm reception that tax restructuring proposals have found in Congress.

I am testifying today on behalf of Dart & Kraft and as a representative of the large and growing number of companies, of all sizes, in many diverse industries, which support tax reform. This support comes not only from companies paying high taxes, but also from companies which recognize the high cost of the various biases inherent in the present tax system.

Dart & Kraft is a diversified, multinational company with 1984 sales totaling $9.8 billion. We rank solidly among the top 50 industrial companies. We employ a total of 72,000 employees worldwide, 45,000 of whom work in the United States. In addition, our direct selling business operates through an independent U. S. dealer force of over 85,000. At year end, we had over 70,000 shareholders.

Our quality food brands include Kraft, Parkay, Miracle Whip, Velveeta, Cracker Barrel, Breyers, and Sealtest. Our other consumer brands include Duracell, West Bend, and Tupperware.

We manufacture Hobart commercial equipment and the leading U. S. brand of decorative laminates for residential and commercial applications under the Wilsonart name. Finally, we have a significant involvement in leasing through our finance subsidiary.

As you can see, we are not only in the food business, but also in heavy manufacturing and other capital-intensive industries. Speaking as Chairman of this diverse group of businesses and fully recognizing that some of our businesses will be adversely affected, I wholeheartedly support the comprehensive tax reform that is so desperately needed.

The time for tax reform is now. The public wants tax reform. Democrats and Republicans alike have voiced their strong support for tax reform. Economists and tax experts favor tax reform. And I am here today to tell you that the mainstream of American business is on your side -- we, too, want tax reform.

Our essential goal is to provide a tax system that is perceived by most Americans to be fair, while raising sufficient revenue to pay for the cost of government and society's needs. A recent poll by the Washington Post and ABC News demonstrates the failure of the present tax system -- nearly three-fourths of those responding felt it was unfair to working men and women.

To be fair, our tax system must be impartial and equitable. It will be impartial when similarly situated taxpayers are taxed similarly. We should not allow our tax system to favor one taxpayer over another, to favor one industry over another, or to favor one kind of investment over another. At the same time, our social goals and moral principles dictate that we temper our impartiality with a very limited number of equitable exceptions to protect low-income individuals, encourage small businesses, and cushion people from hardships. By combining impartiality with equity, we can achieve fairness in our tax system.

In the seventy-two years since it was first enacted, the U.S. income tax system has become so complex that it is virtually incomprehensible. We have today an Internal Revenue Code containing thousands of sections, interpreted by thousands of regulations, thousands of rulings, thousands of court cases, and thousands of pages of commentary written by thousands of experts. Most of this complexity can be attributed to special preferences, exceptions, and shelters used by relatively few taxpayers. These provisions narrow the tax base and require high tax rates on the tax base that remains.

Only by removing numerous special interest provisions can we approach a more neutral, fairer, and simpler tax system. This would permit lower tax rates for individuals and corporations with no revenue loss.

The present U.S. tax system favors spending and borrowing. We must reduce the bias against saving and encourage investment in productive assets for sound economic growth.

We are now, unfortunately, at the point where tax considerations not only outweigh but may even override economic considerations in business decisions. We believe this situation should not be allowed to continue because it restrains economic growth -- the engine for producing more jobs and better lives for all Americans. Every time a businessman makes a tax-motivated decision instead of a market-motivated decision, every time he invests for tax savings instead of research, the economy is weakened a little bit more.

The U.S. tax system is based on self assessment. Each year taxpayers report their incomes and determine their own tax liabilities. Unlike many others around the world, U. S. taxpayers have displayed a very high degree of voluntary compliance -- until recent years. The erosion of voluntary compliance can be traced directly to the increased complexity and perceived inequities in the present tax system. This has resulted in explosive growth in the so-called underground economy, with estimates of untaxed income ranging up to $100 billion annually. Taxpayer confidence in our tax system must be restored. I believe the President's proposal can restore that confidence.

Never before has the Congress, the Administration, and the public been so united in support of a restructuring effort. The time is past for patching our tax system; piecemeal reform efforts have historically produced far more complexity than fairness. We need a wholesale restructuring effort, with no special interest exempt from the process.

We do not expect Congress to rubber-stamp the President's proposal. We do ask, however, that you and your committee keep in mind the goals of economic neutrality and fairness as various interest groups seek both worthy and unworthy changes. Confidence in our tax system and the vitality of our economy are at stake.

A central theme of all of the restructuring proposals is rate reduction -- for individuals and for corporations. Dart & Kraft joins with, I'm sure, every American taxpayer in favoring rate reduction. We do so, recognizing that we will sacrifice long-standing and valuable tax benefits, but accept these losses because we believe the corporate rate reduction to 33 percent will increase our tax system's fairness.

Corporate and individual rate reduction will encourage greater effort and better investment choices, leading in the long run to stronger growth and better jobs for working men and women.

One benefit of rate reduction will be a more equitable distribution of the tax burden among corporations. The fact that some corporations pay little or no federal taxes is not the fault of those corporations. They are merely following the many social and economic directives found in the tax code and, at the same time, minimizing their tax liability. All industries -- for example, food, steel, oil, etc. -- are vital to the U. S. There is no compelling reason why all profitable companies should not be taxed alike.

Additional benefits of rate reduction will be increased savings and investment by individuals and businesses. Americans will save more because they will be able to keep more of the rewards for their efforts. Americans will make better investments because their decisions will be based on sound economic motives and not dictated by the tax system.

From our perspective, one of the most important elements of the President's proposal is the partial deduction for dividends paid by corporations. The current system taxes corporate earnings twice, once in the hands of the corporation and again in the hands of its shareholders.

I note with approval the statement in the President's proposal that "to alleviate the double taxation of dividends, the principle of corporate dividend deductibility should be established, with an initial deductible amount of 10 percent." We favor the Treasury Department's initial recommendation for a 50-percent deduction, and urge you to return to the higher percentage.

The double taxation of dividends encourages corporations to borrow rather than to raise equity. This increases their vulnerability to cyclical changes in the economy. The double taxation of dividends artificially increases the cost of capital for corporations and retards the flow of capital to corporate enterprise. Besides, it simply is not fair to corporate shareholders or their customers.

We have serious concerns about the provision that would recapture a portion of the depreciation taken in years prior to the proposed reduction in rates. The recapture provision was not a part of the November Treasury package and has not been subject to the same scrutiny that other provisions have undergone. It breaks with the historic practice of Congress to make adverse tax changes effective solely on a prospective basis and raises Constitutional concerns. We feel that the past practice is the proper one and we strongly recommend that the Congress reach a fairer method of restoring revenue neutrality.

A final recommendation for your consideration -- the rate reductions and the base broadening provisions should be made effective at the same time. To do otherwise would taint a proposal founded on fairness.

By expressing these concerns, I am not conditioning our support for tax restructuring in general and the President's proposal in particular. I am merely suggesting possible improvements for your consideration. These improvements must be made in the context of revenue neutrality. I would suggest that retained special interest provisions be reviewed as possible sources of additional revenue.

This committee will play a role in tax reform that is in many ways more difficult and more critical than the President's. We recognize that basic restructuring of the tax law is risky, that it requires great courage and the highest degree of leadership -- and yet the reward to the country will make it all worthwhile. You must create the consensus in support of tax reform legislation founded on fairness. You must resist the entreaties of special interest groups, both worthy and unworthy. You must distinguish between alterations to improve its fit and changes that would destroy its fabric. You and your nearly 500 colleagues in Congress will determine the ultimate success or failure of tax reform. Dart & Kraft and a large portion of the business community are prepared to help you in this historic undertaking.

I will be happy to respond to any questions you may have.

### STATEMENT OF WILLIAM W. BERRY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, DOMINION RESOURCES (VIRGINIA POWER, NORTH CAROLINA POWER, AND VIRGINIA NATURAL GAS), RICHMOND, VA

Mr. **Berry**. I am William W. Berry, chairman and chief executive officer of Dominion Resources, whose principal subsidiary does businesses in three States as Virginia Power, Virginia Natural Gas, North Carolina Power, and West Virginia Power. We are the 12th largest electric utility serving 1.4 million customers, and on their behalf, I am here to reiterate our support of the President's tax reform proposal.

We support this proposal just as we supported the earlier Treasury proposal because of its general benefits in improving economic efficiency and equity and also because of its specific benefits to our customers. We have carried out detailed analyses using our corporate planning models, resulting in the most thorough and realistic analysis yet done in our industry.

The results show that electric rates will be about 5 percent lower with tax reform than they would otherwise be in 1987, 1988, and 1989. That represents savings of about $40 a year for a typical residential customer and total savings over the next 4 years of over a half a billion dollars in electric rates.

In addition, we believe the President's program will reduce the cost of capital. The key elements that produce these favorable results for customers are the lower corporate tax rates, deductions for dividends paid, and an inflation indexed depreciation system. The 10-percent deduction for dividends paid is an important ground-breaking step toward elimination of the double taxation of dividends. It should be expanded as resources permit. The inflation indexed depreciation system would reduce the risk of investment in long-lived assets and improve efficiency by reducing inequity in the treatment of different kinds of assets.

We are a capital-intensive company in a capital intensive industry. Although we are completing this year our last major generating construction project, we will still need to invest over $600 million a year to provide service to new customers, upgrade and extend the life of existing facilities, and meet the energy needs of a growing economy. The President's proposal will have a significant adverse effect on our cash-flow, and that is one reason that appropriate transition rules are important. Everybody will find something they don't like, some preference they would like to keep, but we must look at the whole package. I believe it is a good proposal. It should be enacted, and it should be done promptly. Thank you.

The **Chairman**. Thank you, sir. Mr. Smith.

[The prepared written statement of Mr. Berry follows:]

# STATEMENT OF

## WILLIAM W. BERRY

CHAIRMAN AND CHIEF EXECUTIVE OFFICER
DOMINION RESOURCES, INC.

ON

TAX REFORM

Before the
Senate Finance Committee
United States Senate

June 13, 1985

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am William W. Berry, Chairman and Chief Executive Officer of Dominion Resources, whose principal subsidiary, Virginia Electric and Power Company, does business in three states as Virginia Power, Virginia Natural Gas, North Carolina Power, and West Virginia Power. Our electric utility is the twelfth largest investor-owned electric utility in the country and accounts for approximately 95 percent of our company's revenues.

I am here today on behalf of our 225,000 shareholders and 1.4 million customers to restate our company's support for tax reform as recommended in "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity."

In early March of this year, I wrote to Treasury Secretary Baker, and to Members of Congress from the three states we serve, telling them that we support the Administration's efforts for comprehensive tax reform. I met in April with Treasury Assistant Secretary Pearlman to reaffirm that support.

Our early advocacy of tax reform -- based largely on belief in the underlying principles -- has been fortified by computer simulations of the effect the proposals will have on our company and its customers during the remainder of the 1980's.

Our primary reason for advocating the reform proposals is a compelling one: Our studies show that the lower proposed tax rates will reduce the cost of electricity to our customers by a significant amount -- as much as 5 percent below what they otherwise would be -- by the end of the 1980's.

Moreover, we believe this important customer benefit will be achieved without an overall adverse impact on our shareholders.

Our customers and our shareholders also stand to benefit from the reductions in the cost of capital that are expected from the tax reform package. Secretary Baker has estimated capital cost reductions of 20 percent.

Our company and industry require extraordinary amounts of capital to provide a fundamental public service -- electric power. For too long, we and our customers have borne the burdensome expense of competing for capital with investors driven largely by tax incentives to raise money for investments of questionable value to the Nation's economy. Tax reform holds the promise of ending this distortion of our economy.

In 1984, the Dominion Resources companies had revenues of $2.6 billion, assets of $8.1 billion, and 14,000 employees. Our utility subsidiaries serve some 1.4 million electric and gas customers, spanning a service territory of approximately 32,000 square miles in Virginia, North Carolina, and West Virginia. We generate electric power from 4 nuclear, 14 coal-fired, 3 oil-fired, and 9 small hydroelectric units. This year we will complete the world's largest pumped storage hydroelectric facility. We are a capital-intensive company, in one of the Nation's most capital-intensive industries.

Our company has benefited from existing tax provisions designed to encourage capital investment and provide capital cost recovery. We have used those provisions in building much-needed generating, transmission, and distribution capacity to provide service to our customers. Nevertheless, we believe those provisions are in need of change.

In our view, investment will be encouraged and allocated more efficiently, and more fairly, by lower corporate tax rates and a reduction of the double taxation of corporate earnings paid as dividends, rather than by continued use of specific incentives such as the investment tax credit. The President's proposal for a deduction for dividends paid is a long overdue step toward fairness.

As Secretary Baker testified before the Ways and Means Committee two weeks ago, current law imposes tax on corporate income at two levels -- once at the corporate level and once at the shareholder level. That double taxation causes underinvestment in the corporate sector, and it encourages the use of debt financing when equity financing may be more appropriate.

We agree with Secretary Baker that the President's proposal for a deduction for 10 percent of dividends paid is an important start in reversing this misguided tax policy. We are hopeful that this modest first step would be followed by increases in the deduction for dividends paid as revenue considerations allow. We would expect that the benefit of that deduction would flow directly to our customers.

As to capital cost recovery, it is desirable that depreciation allowances provide for full cost recovery in real terms regardless of whether the inflation rate is high or low.

Investment is deterred by uncertainty about future inflation and therefore about whether the replacement cost of the investment can be recovered. A properly designed inflation-indexed capital cost recovery system would directly address this problem and thereby give strong encouragement to productive assets, particularly longer-lived assets such as those in our industry.

The President's proposals for capital cost recovery adopt an inflation-indexed system, and also address most of the imbalances and technical difficulties present in the Treasury Department's November 1984 Report to the President. Accordingly, we support the President's proposal for a new Capital Cost Recovery System.

In reaching our decision to support the President's tax reform proposals, we endeavored to evaluate the package as a whole. There obviously are proposals that hurt, and there obviously are proposals that help. In the short term, we have found that our cash flow will be adversely affected, but, more importantly, we also have found that our customers will benefit. Thus, we have concluded that, taken as a whole, the President's package is an excellent program. I hope this Committee will support the package in all its essential elements.

There are details of the President's proposals that will require close examination and perhaps modification. That does not, however, detract from our support of the purposes and principles of the President's proposals. Nor does it mean that the need for close examination or for orderly transition rules should serve as an excuse for unnecessary delay. Tax reform is important work, and extended delay in enactment will hamper and disrupt business decision-making. Prompt action is required.

Mr. Chairman, I end by emphasizing that our company, all of American business, the President, and the Congress have a common goal of fortifying the credibility of our tax system with the American people. The President and Secretary Baker have correctly stated that both the complexity of our tax laws and high tax rates undermine faith in our system of government. I can tell you from painful experience that the rapid increases in the cost of electricity in the 1970's almost destroyed the credibility of the power industry.

In the 1980's, my company has gone a long way toward restoring credibility by holding our price increases to less than one-fourth of the increases in the cost of living as measured by the Consumer Price Index. Tax reform offers us another tool for control of electric energy prices. Secretary Baker has perceptively observed that we cannot expect to achieve tax reform unless we are all convinced that there is a clear and compelling need for reform. From our viewpoint, the need to reduce the price of electricity is always a clear and compelling one for all Americans. We believe enactment of the reform package will deliver that benefit and the others apparent in the President's proposals.

We are eager to do our part.

I will be pleased to respond to any questions you may have.

## STATEMENT OF PHILIP L. SMITH, PRESIDENT AND CHIEF OPERATING OFFICER, GENERAL FOODS CORP., WHITE PLAINS, NY

Mr. SMITH. Mr. Chairman and members of the committee, I am Phil Smith, the chief operating officer and president of General Foods. We are a major food company with revenues of over $9 billion. I am very appreciative of the opportunity to express my company's view on tax reform. I am going to confine my remarks to the effect on the corporate sector.

I would like to make it very clear from the outset that General Foods supports the growing move toward tax reform. We do so because we believe that the current tax system violates five major principles of sound tax policy.

The first is fairness, wherein equivalent economic incomes for different corporations are taxed at different effective rates.

The second is neutrality, wherein our current Tax Code does favor certain classes of investment.

The third is efficiency. When we have a tax system that has as many tax preferences as our current system, we have poor allocation of resources in unsound investment areas. This system inevitably generates high marginal rates which does not promote economic growth.

The fourth is stability. With a system with as many tax preferences as our tax system has, it is one that is bound to be frequently revised. In fact, this system that we have today has been revised eight times since 1968. That hardly promotes the long-term view that we think is most important for an investment policy.

The final principle is simplicity. The current tax system is really beyond the comprehension of any single tax expert. The result has been, in our judgment, an erosion of public faith in our tax system. It has led to abuse and to noncompliance.

We believe that it is possible to correct the deficiencies of the current system. Correction must broaden the base and, in broadening the base, allow for lower tax rates; find some way to avoid the double taxation of dividends, that will lessen the bias toward debt financing; deal with the disparities in rates between various companies, and end the bias for certain classes of investments.

It is our belief that the administration proposal does in fact address many of the issues in the current tax system. It broadens the base by eliminating many tax preferences. Rates are substantially lowered. We believe that it will reduce the inequities between rates of various companies and provide some relief for the double taxation of dividends.

That is not to say that the proposal does not have issues. One of the major issues, which has been mentioned frequently here already, is the decision made by the Treasury to penalize retroactively the investment decisions made in the past. I think this can do nothing but erode confidence in making decisions, and in fact, it is a retroactive tax increase. It is not an academic decision because it has a sizable cash-flow impact on many of our companies.

Now, despite this issue, taken as a whole, we believe that the administration proposal takes meaningful steps toward correcting the deficiencies in the current system. As the Congress moves forward to debate this and determine what legislation should come forward, it is our hope that this basic structure will be retained, and that in addition we would question those preferences which are still left in the system, and we should avoid adding new ones. The net effect, we believe, can be a tax proposal that General Foods would be delighted to support. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Smith follows:]

TESTIMONY OF

PHILIP L. SMITH

PRESIDENT AND CHIEF OPERATING OFFICER

GENERAL FOODS CORPORATION

WHITE PLAINS, NEW YORK

SENATE FINANCE COMMITTEE

JUNE 13, 1985

Mr. Chairman, Members of the Committee, my name is Phil Smith and I am the President and Chief Operating Officer of General Foods Corporation.

You may recognize us more by some of our brand names, which include Maxwell House Coffee, Jell-O desserts, Oscar Mayer meat products and Entenmann's baked goods. In total, we have more than 56,000 employees worldwide, including 37,000 in the United States. We have office and production facilities located in 35 states and Puerto Rico. Our annual revenues exceed $9 billion.

I want to thank you for the opportunity to express my views and the position of my company concerning federal tax policy. I'll be confining my remarks to the effect of tax policy on the corporate sector.

Let me say right at the start that we strongly support the growing effort to reform our tax system.

The need for change has never been clearer. Nor so widely recognized. The popular support for fundamental tax reform is great. And it's building. I find it equally impressive that here in Congress the view in favor of reform is so broadly shared by the leaders of both parties.

We in General Foods believe there are at least five principles of sound tax policy that the current tax system violates.

The first is fairness. The reported income of corporations is taxed at differing rates under the present law. For example, Congressional studies have shown that effective tax rates for major profitable corporations range from zero to 35 percent. The imbalance created by investment tax credits and accelerated depreciation is a major reason.

These incentives also have the effect of taking a growing number of companies into businesses they'd probably prefer not to be in.

General Foods is an example. We are a highly successful and dynamic food and beverage company. More than 75 percent of our revenues come from brands that are number one in their market. More than 30 percent come from businesses we had not even entered five years ago. Our mission is to be the premier food and beverage company in the world through providing superior satisfaction to consumers.

Yet because our effective tax rate has been so high, we have established a credit corporation to lease unrelated capital equipment to other companies and lower our rate. Under present tax policy, we feel we have little choice if we are going to stay competitive and earn for our stockholders the returns they deserve.

But we'd rather see tax policy changed so it isn't necessary. We'd prefer to stick to what we know best -- the food and beverage business.

The second principle the tax code violates is neutrality. And, again, investment incentives are a prime example. In effect, they represent an implicit national industrial policy that favors a certain class of investment. We believe investments ought to be made on the basis of economic merit and not conditioned by discriminatory tax policy.

Which leads to the third violated principle -- and that's efficiency. Not only have we stimulated poor investments. Over time the erosion of the tax base has become a powerful deterrent to economic growth. With the resulting rates so high, investors must earn a higher return than they otherwise would in order to pay Uncle Sam and still show a decent profit. As a result, it's entirely possible that many sound investments are simply never made, and that's plain inefficient.

The fourth principle of good tax policy we've violated is stability. We've had eight major revisions to the tax law since 1968.

You know, for years American business has been criticized for a lack of long-term planning. At times the criticism has been deserved. But I must say that a major revision in the tax law every few years does tend to shorten your horizon a bit.

This is not to say that Congress should never act for legitimate social purposes or to help an ailing industry. But, in our opinion, the tax code is not the preferred instrument. We would prefer to see the direct subsidy route used. Then the action could be debated more openly; there would be no question of its cost. For as you well know, when a program is paid for out of a reduction in tax revenues, the cost is very difficult to measure.

The fifth principle is simplicity. The tax code is exceptionally complex. So complex that no single tax expert could possibly comprehend it all. Compliance with the code -- that is, simply doing the staff work needed to feel reasonably sure that we have complied -- has become a significant cost center for most business enterprises. But more important, in my opinion, is the loss of credibility and support that occurs when the system can no longer be understood.

Overall, then, if you look at these five principles and compare them with current tax policy, the consequences are plain to see. The integrity of the tax system as an impartial raiser of government revenues has deteriorated. Public faith in the system has eroded, leading to abuses and noncompliance. The issue, it seems clear to me, is not whether the income tax system requires change. But rather what basic revisions can best correct these significant deficiencies.

Following the principles of fairness, neutrality, efficiency, stability and simplicity, it would be reasonable to support these four revisions:

One, that the tax base be broadened and rates be lowered. This will restore a sense of fairness and confidence in the system. And it will improve economic incentive, efficiency and decision-making.

Two, that corporate income should be subject to tax only once. The double taxation of corporate dividends distorts financing decisions to favor debt over equity to a degree that may not be in the best interests of a sound economy.

Three, that the disparity be eliminated between the effective tax rates of corporations with similar reported income.

Four, that the imbalance for or against certain classes of investment be eliminated. The market, and not the tax law, should determine the businesses we enter and how we finance and manage them.

We believe these four basic revisions would restore public faith in the system and elevate public perception of the fairness of our tax laws.

They also would provide the basis for stabilizing the tax code so that frequent and complex changes would not be necessary.

We think it is important to recognize the effects that a change in the tax code will have. Change will be disruptive and will no doubt alter economic behavior. The length of the transition period will not affect the amount of disruption. We believe the transition period should be as brief as possible so as not to delay the reform process and dilute its economic benefits.

Taking into consideration the principles we believe constitute good tax policy, we think the Administration's proposal is responsive to many significant deficiencies in the current law.

Specifically, the proposal would substantially broaden the tax base by eliminating many tax preferences. Rates would be lowered and reduced in number, with the result of greater fairness and economic incentive.

The proposal would reduce greatly inequities in effective corporate tax rates and would provide some relief from the double taxation of corporate dividends.

We believe the decision not to impose a burdensome tax on employee benefits is sound and will keep the delivery of these benefits largely in the private sector where it belongs.

Overall then, we support this proposal. But our support is not unqualified. For instance, we feel that the proposal, particularly with regard to depreciation, depreciation recapture, indexing, and the minimum tax, will not simplify our tax laws.

Regarding the deductibility of dividends, it is disappointing that the proposal would permit only a 10 percent deduction, thus continuing the double taxation of 90 percent of corporate dividends. This hardly qualifies as fair.

The most significant disagreement we have is with the provision to penalize retroactively investment decisions made under existing tax law. Specifically, I'm referring to the attempt to recapture depreciation costs already accounted for in past tax years.

This provision would cause us to revisit the depreciation charges made by our company between January 1, 1980 and June 30, 1986 -- all of which were deducted on an accelerated basis. We would then have to calculate the difference between these original deductions and what they would have been on a straight line basis using different depreciation lives. Forty percent of this difference -- the so-called excess depreciation or windfall -- would then be subjected to a new 33 percent tax rate.

The nicest thing we can say about this provision is that it makes no sense from a financial point of view. It converts an expense item from our balance sheet into an income item on our tax return.

But much more important, this provision applies a change in tax law retroactively. In doing so, it has no precedent. Moreover, it can only erode the confidence of taxpayers if the decisions they make today are to be undone by the government tomorrow.

This erosion of confidence is more than a theoretical concern for us. At General Foods, this provision would have an immediate and sizable impact on our cash position. We estimate compliance would cost us about $100 million. A figure which, to give you a means of comparison, would fund most of our research and development activities for a full year -- an expenditure, by the way, which is the largest in the food industry.

Mr. Chairman, I have to believe the people at Treasury had their tongues in their cheeks when they called this provision a windfall profits tax. Because, in effect, what they have done is given business a six-year retroactive tax increase. That's hardly a windfall for business.

By comparison, the provision for protecting investments in Puerto Rico over a five-year period is an example of the proper way to handle transition to a new tax system.

Despite our continuing concern with these particular provisions, we believe the proposal, when viewed in its totality, takes meaningful steps to eliminate tax preferences and broaden the tax base. Congress may wish to pursue this effort further.

Let us suggest again that the basic principle of fairness should be the deciding factor as you continue your deliberations. The end result of your hearings, we hope, will be a bill which better equalizes the tax burden across all industries.

Mr. Chairman, my company and I stand ready to help in any way we can your efforts to meet this important national priority.

Thank you.

The **Chairman**. Let me start with you if I might, Mr. Smith, because in your statement you specifically say that, if we are going to go beyond the marketplace with certain industries, we ought to subsidize them—just be out and out about it and rebate the subsidy, rather than using the Tax Code. And I will come back again to some of the examples that we have used, that you probably heard when you were in the audience before.

With shipbuilding, that is what we do. When we say we are going to build the ships in America because it is necessary for national defense, so we build our military ships here. We don't do that with commercial ships, and the commercial ships, therefore, get built overseas. And the argument is made in the maritime industry that we are going to be very short of transport capacity and ship repair capacity because we don't build them in this country. Assuming we accepted that argument, your position would be that we ought to do something akin to what we do with military ships, rather than a tax incentive for commercial shipbuilding?

Mr. **Smith**. Our belief is that the tax system that would work best for our economy would be one that would avoid as many preferences as we could. If there is a specific issue that is important to the national defense, as judged by the Congress and by the administration, then that should be dealt with on a direct subsidy basis. That should be a very tight definition and one which I believe that most people in my position are not really qualified to make judgments about.

The **Chairman**. That is a decision the administration made when they decided to keep the intangible drilling cost deductions for the natural gas and oil industry. And the argument that is used is that it is for national security. Now, that premise is going to be debated before we are done with this, but we will see where that comes out. Assuming the premise to be right, then the alternative would be a Synfuels Corporation, a reconstruction finance corporation, a Government guaranteed loan—something of that nature that would give preference to that industry, other than the use of the Tax Code. For many years, many business people have said, given those two choices, they find the Government so inefficient at managing programs, they would rather have the Tax Code used as an incentive if you give us the premise that we want to achieve something beyond the marketplace. What I hear you saying now is that, given the choice, you would rather have the Government-managed program, however inept that may be, than using the Tax Code for the incentive to achieve roughly the same end.

Mr. **Smith**. Mr. Chairman, I would like to make it clear that I am not willing to accept the premise that you have put forward that this is an issue of national security.

The **Chairman**. I am not either. I am saying that assuming that you accept a premise that for some reason we need to encourage something beyond the marketplace. We do it with homebuilding when we allow mortgage interest deductions. We say it is good for people to own homes, and they will own more of them if we let them deduct the interest from their income tax. That is going beyond the marketplace.

Mr. **Smith**. If it is so adjudged to be that kind of an issue, I believe that issue is better debated and done openly on a specific basis than dealt with in the Tax Code.

The **Chairman**. Could I ask the other two of you to comment?

Mr. **Berry**. I would like to comment. I would say we ought to get the tax preferences out of the tax system and make it neutral, and we ought not to have the subsidies. You have forced us to make a choice between the two, but I think we should, to the greatest extent possible, have neither and that there should be a heavy burden in proving a national defense requirement before we start intervening in the free marketplace. But to answer your question, if that heavy burden is borne and we decide we do have to intervene in the marketplace, I think it is better to do it directly because then we know what the costs are. We can measure the costs.

And second, they are very visible and therefore subject to scrutiny and challenge. When we manipulate the tax system to produce those incentives—we don't really know what that cost is.

The **Chairman**. Mr. Richman.

Mr. **Richman**. I think Bill Berry stated it just right at the end there. Either way, the Government is paying money out in subsidies. You lose control of it, it seems to me, when you put a provision in the Tax Code and it stays in there forever.

The **Chairman**. Then, let me ask you this on the personal side. Should we take that same view toward charitable deductions? Rather than allowing the deduction, which is a distortion of the Tax Code on the personal side, the Government will finance those charities that we think are worthwhile.

Mr. **Richman**. I can see a difference, Senator, between the individual side and the corporate side in this regard. Many charities have been built up over time based on this charitable deduction. It seems to me that, if you were starting totally afresh and no one ever heard of a charitable deduction, I think I might agree with what you just said might be the policy. But I think that this would be such a wrench to the system that I would prefer to see us continue the charitable deductions.

The **Chairman**. Mr. Berry.

Mr. **Berry**. My range of choices would be, first, to let the market work. But there are instances such as human service needs that are met by charities that the marketplace is not going to meet. When the marketplace fails to meet a need, a second choice would be the volunteer system that we have uniquely in this country, and to me, we ought to encourage that, not discourage it. And the last step——

The **Chairman**. You would encourage it with a tax preference?

Mr. **Berry**. To allow the deduction of charitable contributions. and encourage the volunteer sector to handle it. And the last choice is for the Government to handle it directly.

The **Chairman**. Mr. Smith.

Mr. **Smith**. I support that view.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman. I am glad to see that this panel profitted from the experience of the previous panel. [Laughter.]

And I would like to ask each of you a question. Will you pay more or less tax under the Treasury proposal?

Mr. **Richman**. Our company will pay somewhat more for about 3 years, and after that, it should level off and eventually pay less. Our book earnings, from an accounting standpoint, will show an improvement because of the effect the lower rates have on our provision for taxes.

Mr. **Berry**. Lower that what? Lower than Treasury I or lower than what we have been paying?

Senator **Bradley**. Lower than what you have been paying.

Mr. **Richman**. That is what I assumed you were asking.

Senator **Bradley**. Yes.

Mr. **Berry**. Under either Treasury I or the President's proposal, we will pay more than we have been paying. We have been a very low effective tax rate company. We look forward to paying a higher effective rate.

Senator **Bradley**. All right. Mr. Smith.

Mr. **Smith**. We will pay more for the first 4 years and then, thereafter, we will benefit.

Senator **Bradley**. The question, I guess, should be asked as I asked the previous panel. If you are going to pay more in tax, why are you for tax reform?

Mr. **Richman**. I think for a couple of reasons, Senator. We talk about this level playing field, and that is very important. That is very important in terms of investment. It is very important in terms of allocation of resources. And we would like to be treated like everybody else and have companies similarly situated in terms of earnings pay similar taxes. So, that is very much of a motivation for us, besides which, I think, contrary to what has been said this morning, I think this is a progrowth approach for the country. I simply can't believe that if you lower tax rates by 13 percent, that over time this isn't going to promote growth in the economy, and I think you are talking today to some pretty large corporations, but when you get out and talk to small business—and I am sure you will hear representatives of that sector—and that is where a lot of the growth in this country is coming from, small business—

Senator **Bradley**. So, would it be incorrect to characterize what you have said—I think it would be correct to say that, yes, you are going to pay more in tax for a couple of years, but you believe that the effect of the overall rate reduction is going to be that over time you are going to do well because you are good at what you do. And with the lower rate, if you make more, you will keep more, and that should be reflected in your share price and everything else. Is that a fair statement?

Mr. **Richman**. You said it a lot better than I did, Senator. That is exactly right.

Senator **Bradley**. Would you agree with that?

Mr. **Berry**. I would add just one other feature to it. One of the reasons we have paid low effective tax rates is because of high investment tax credits. And those investment tax credits create, particularly for a regulated company, enormous intergenerational inequities. We get a tax benefit associated with a plant that is going to last for 30 years. Who gets those benefits? Do you get them all today, or do you share them over the life of the plant?

So, we think this move away from that to an inflation indexed type depreciation system is a big step. We don't think it is necessary or even good to frontload the depreciation system and still not recognize inflation. We think the key element in this system is that it does recognize inflation and, for us, it doesn't create nearly as much of an intergenerational issue about who gets the benefits and who pays the cost.

Senator **BRADLEY**. Mr. Smith.

Mr. **SMITH**. Senator, it is our belief that we have to be competitive with other industry in our capital-raising capacity. And as other industries have been able to work their tax rate down, we have aggressively followed the same practices. So when a proposal of this sort goes into place, in effect we end up paying somewhat more over the near term, but what we avoid is engaging in activities that are not central to our basic business. And if we are able to focus our energies on our major business, we are going to prosper in the long run.

Senator **BRADLEY**. In other words, you are saying with a level playing field with all industries treated relatively equally by the Tax Code that you think you would do OK.

Mr. **SMITH**. Absolutely.

Senator **BRADLEY**. And you are willing to compete?

Mr. **SMITH**. Absolutely.

Senator **BRADLEY**. Would all of you agree that we want—if we did tax reform, we do not want it to increase the deficit?

Mr. **RICHMAN**. I would.

Mr. **BERRY**. Yes.

Mr. **SMITH**. Yes.

Senator **BRADLEY**. Do all of you agree that if we do tax reform, we do not want to increase the relative tax burden on middle or low income people?

Mr. **BERRY**. I would agree with one caveat, and that, to me, is one example of what is wrong with the present tax system. We have a lot of moderate income people who are involved in, I think, some pretty squirrelly tax shelters, and if we eliminate those tax shelters and those people pay more, I think that is another right step.

Senator **BRADLEY**. What if I were to give you a couple of statistics that would show that squirrelly tax shelters are not the province of middle income but clearly the province of upper income?

Mr. **BERRY**. I agree that is where most of it is. What I am saying is that I know of examples of middle-income people who are involved in apartments and oil drilling, and they don't have any business being in there any more than upper income people.

Senator **BRADLEY**. Because they are going to lose their money. Right?

Mr. **BERRY**. I am afraid that is the case. They forget the economics of the project and look only at the tax benefits, and we should eliminate that even if it affects a few, and I will admit that a few——

Senator **BRADLEY**. And by eliminating that, we give those same middle income people a lower tax rate.

Mr. **BERRY**. That is right.

Senator **BRADLEY**. Mr. Smith.

Mr. **Smith**. To the extent that that is possible, I agree. I do feel that in lowering the top rate, you are bound to have some skew in there.

Senator **Bradley**. The key, though, is the lowest rate for the greatest number of people.

Mr. **Smith**. Right.

Senator **Bradley**. Not just the lowest rate for the upper 3 percent of the population, but the lowest rate for the greatest number. So, people who work in your companies——

Mr. **Smith**. I agree.

Senator **Bradley**. They work longer, harder, overtime. They keep more of their money.

Mr. **Smith**. I agree.

Mr. **Richman**. I agree with that, Senator, as a general proposition. I think you get skews depending on—I have seen studies on whether you draw the line at $50,000 or $70,000 or $80,000, and so on.

Senator **Bradley**. We heard the previous panel and they are all upset about recapture, and there are other groups of people who are upset about this or that. There are certain things in this administration proposal that are clearly tax preferences. I guess the most obvious one that comes to the attention of this committee is the intangible drilling costs. Do you think we should treat that like we treat all other preferences? If we could put a red circle around the national security argument because I know that at least three of us will be fairly interested to plumb that at some depth, but do you think we should look at it just as we looked at depreciation, just as we looked at R&D tax credits, just as we looked at other things. Don't you think we should really give the IDC a very careful look?

Mr. **Richman**. I think you should.

Mr. **Berry**. I would say you ought to look at any of the special provisions that are in here and see if they can't be eliminated, and please don't add any more. [Laughter.]

Mr. **Smith**. I support that.

Senator **Bradley**. Let me say that, in closing, I am very glad to see you gentlemen here today, and I think that the fact that you haven't been here in previous years and other people have might explain why you got a high effective tax rate and they have a very low effective tax rate. So, I am pleased to see you here fighting for the general interest, which is getting everybody's tax rates down.

The **Chairman**. Senator Grassley.

Senator **Grassley**. I think my point would follow very well on just the last statement he made. How do you feel so strongly about the general approach in the proposal, the extent to which you are willing to educate your employees, encourage people to become involved? Are you doing anything along that line, and do business associates of yours who feel like you do who aren't here today—is there an organized effort to do that?

And I would like to know specifically what you might be doing. And then the premise of the question is, quite frankly, based on the fact that, if this is going to be sold, it is going to have to come from a grassroots, prairie-type fire approach to getting the message through here to Washington because obviously we are going to be hearing from the special interests who don't want the bill passed, and to a great extent we have already. So, I guess I ask that as a way of finding out your commitment to the whole process.

Mr. RICHMAN. Senator, I can start out. We had our annual meeting of shareholders a few weeks ago, and I addressed some of my remarks at our annual meeting to this issue. We are sending those remarks out to all of our employees, all of our shareholders. I view my testimony here today, my testimony last week before the Ways and Means Committee as a commitment for the duration here. And we intend to keep on doing that sort of thing.

Mr. BERRY. We got in this process early in supporting the Treasury proposal. We have been lobbying our associates within the industry, and I think with some success. We have only got 12,000 employees. I think they will be supportive, but the key, as you point out, is the grassroots, and there, I think, our effective selling point will be the favorable effect it will have on 1.4 million customers.

Mr. SMITH. I would just say that General Foods has been in support of tax reform for some period of time now. I personally have made speeches in public forums talking about various issues in the tax reform. We have written articles in our company newspapers and sent them out. I belong to the Grocery Manufacturers Association Tax Committee. I chair that committee, and we have developed there a position in support of tax reform, and we are continuing to aggressively push that position here, as you saw from Mr. Bryan's testimony.

Senator GRASSLEY. Each of your responses sound good and a good start. I would just suggest theh a followthrough that is going to be very important, and the extent to which you get your members and your stockholders, and particularly your employees made aware of the issue and the process, but the followthrough comes in the extent to which you motivate them to contact their Congressmen and Senators.

The CHAIRMAN. Let me ask you each a question unrelated to what we have asked before. Mr. Smith, you are headquartered in White Plains. Mr. Berry in Virginia, and Mr. Richman in Northbrook, NY, allegedly ia a high tax State. I assume Virginia has significantly lower taxes than New York, and it may have lower taxes than Illinois. I am not sure. You are familiar with the debate we are having about the deductibility of State and local taxes. Business taxes, you still get to deduct. If we were to eliminate the personal deduction of State and local taxes, would that be a factor in any of your decisions in locating plants? Would you be inclined to locate in a low-tax rather than a high-tax State because deductibility had been eliminated? And I will start over here.

Mr. RICHMAN. I don't believe we would, Senator. The decision to locate in a State involves, as you know, a large list of items that you have to consider, and that would be one that would be fairly far down the list, I think.

The CHAIRMAN. Mr. Berry.

Mr. BERRY. We only operate in three States, and I would say it would not be a factor is over decisions. But beyond that, we are very active in economic development in the area that we serve. And from the people that I have talked to that we have tried to sell Virginia, North Carolina, and West Virginia on, I don't believe it is a factor with them either. So, I don't believe in general it is a factor.

Mr. **Smith**. Mr. Chairman, I don't feel it would be a factor in the location of plants. We do have our headquarters in New York. We are committed to New York State. I think it is exactly the right place for us to be, and I think that this provision would not change our support for that State and our company's presence in it.

The **Chairman**. Even if they lose the deduction?

Mr. **Smith**. That is right.

The **Chairman**. Does White Plains or Westchester County have a county or city income tax?

Mr. **Smith**. New York City does, but the specific area of White Plains does not.

The **Chairman**. Now, let me ask you a last question related to this. And I will preface it by saying that here is the argument that is made. Decisions as to where to locate plants are made by high income executives. That is probably true, the ultimate decision, and they are going to be reluctant to move into a State that has a high income tax. Given the decision that you are looking around at different locations and the total tax level of the States is about the same, but one rests much more heavily on a sales tax than an income tax. Would that be a factor in your executive's decision? The personal income tax level in that State and whether or not you could deduct it in locating a plant, as opposed to locating it in one that has a high sales tax but little or no income tax. Mr. Richman?

Mr. **Richman**. Senator, as I said, there are just an enormous number of considerations in where you set up a plant, and most of them are business decisions as opposed to individual tax decisions. I suppose you could envision a situation where everything else was equal and that became a major swing factor, but I don't really think that is a major consideration.

The **Chairman**. Mr. Berry, what have you discovered in attracting industry?

Mr. **Berry**. I think it ought to be based on business conditions in the State, which would apply to taxes on business within that State, but to me, it is completely inappropriate for an executive to make a decision about locating a plant based on his own personal tax rate. Nobody that works for me will do that.

The **Chairman**. And your experience is that if an industry is looking at Virginia versus North Carolina versus West Virginia, the personal income tax rate that the executives will have to pay and the plant that is located there is a very insignificant factor?

Mr. **Berry**. That is correct.

Mr. **Smith**. I think that, given the magnitude of the business decisions, the logistics issues and those sorts of considerations in locating a plant, it is improbable that this factor would influence that judgment.

The **Chairman**. All right. Gentlemen, thank you very much and thank you for waiting so long while we questioned the first panel. I appreciate it very, very much.

Mr. **Berry**. Thank you, Mr. Chairman.

[Whereupon, at 12:17 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF
WILLIAM R. HOWELL
CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER
J. C. PENNEY COMPANY, INC.
BEFORE
THE COMMITTEE ON FINANCE
UNITED STATES SENATE
June 13, 1985

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Mr. Chairman, I am William R. Howell, Chairman of the Board and Chief Executive Officer of the J. C. Penney Company, Inc. I am pleased to have the opportunity to share our views on the President's proposal to restructure the federal income tax laws.

My comments today also reflect the views of the members of the Retail Tax Committee of Common Interest, a group which includes the chief executive officers of the major retailing companies and the major retail trade associations, whose names are attached to my statement.

## I. Support For Fundamental Tax Restructuring

Mr. Chairman, let me say that we approach the President's package from a perspective referred to by the President: will this package be good for the economy? A reform measure which benefits the economy will be good for the citizens of this country -- our customers -- and good for the future of

J. C. Penney and other businesses. This perspective is consistent with the President's view that "the worth of any economic policy must be measured by the strength of its commitment to American families, the bedrock of our society..." and with Secretary Baker's observation that a reform package must be pro-family, pro-fairness and pro-growth.

In 1913, Mr. Penney and his partners drafted a statement of business philosophy which has guided the management of our company for more than 70 years. It concludes with this statement -- "Does it square with what is right and just?" That question is as pertinent today, if not more so, than it was in 1913. It is in this spirit that I offer these views.

We continue to analyze details of the President's proposal, so I cannot comment in depth on them. But we wish to express very strong support for the commitment by Chairman Packwood and Members of this Committee to the timely consideration of a fundamental restructuring of the corporate and individual income tax laws. Your Committee will encounter many obstacles in this process, from those opposed to all change, and from those who wish to preserve cherished provisions of the tax laws. The objective of tax reform is so important that we sincerely hope that the Congress will be able to focus on the important overall objective of comprehensive reform, and craft a tax reform package which, in Mr. Penney's words, is "right and just."

From retailing's perspective, a reform measure which meets this standard must contain four critical elements:

(1) a substantial reduction in the top corporate tax rate and retention of graduated rates for smaller companies;

(2) an adequate deduction for a portion of dividends paid;

(3) a significant reduction in individual tax rates, increasing consumers' disposable income and ability to save and invest; and

(4) sufficient recognition of the importance of private sector responses to retirement security, health, and insurance needs of our employees.

Consistent with the inclusion of these critical elements, and as long as new substantive issues which will have a significant adverse effect on retailing are not added to those proposed by the President, I pledge my support and that of the J. C. Penney Company for its enactment. The retailing and association executives who join with me in this testimony request that the Committee's record show that they join in this commitment.

The need for a comprehensive change in the income tax laws has been building steadily for a number of years. There is an apparently increasing level of public dissatisfaction with a system that is perceived to be unfair, which has resulted in the growth of a large "underground economy." Unfairness is manifest in the wide divergence in burdens which the present law imposes on various sectors of the economy as reflected in those sectors' effective tax rates. The retailing industry -- which has historically paid taxes at the highest effective rates -- is particularly affected by this disparity.

## II. Corporate Tax Rate Reduction

Turning to our industry's major concern, retailing strongly endorses a substantial reduction in the current 46% corporate tax rate. The President's proposal calls for an immediate reduction of 13 percentage points, bringing the top rate down to 33%.

A reduction of this magnitude -- at least 13 percentage points -- must be retained as the central theme of the corporate provisions of a tax reform package. If the corporate rate is forced above this level, questions will arise concerning the resolve of Congress to enact comprehensive reforms rather than piecemeal, highly selective reforms.

### A. Benefits Of A Lower Corporate Rate

There would be several beneficial effects following a substantial reduction in the corporate tax rate. The overriding benefit would be a significantly smaller tax burden on each dollar which a corporation earns as profit. The reduced tax rate would allow more of the corporation's earnings to be available for investment in jobs, inventory and structures which enable retailers to serve as the vital link between manufacturers and consumers.

Corporate income tax rate reduction would also lessen the current law's bias which urges a corporation to finance its activities through debt, on which interest is deductible, rather than through equity issues, on which dividends are not deductible. A 33% tax rate would at least reduce the imbalance between debt and equity, making the latter more attractive than is now the case.

A third benefit would be a general lessening of the economic value of the whole range of business deductions. In an era of very high tax rates, including a period of high inflation, the availability of special deductions and credits becomes a primary factor in business planning. A 13 percentage point reduction in the corporate tax rate should reduce significantly the impact of tax consequences on business decision-making, allowing managers to focus attention on increasing productivity and sales.

### B. Graduated Rates For Smaller Corporations

One essential element for a desirable package is the retention of lower rates for smaller corporations. While the larger retailing companies, such as J. C. Penney Company, do not benefit from the current graduated rates, the vast majority of retailers -- representing some 80 percent of our industry's sales -- are small businesses. For those companies, lower rates on the first $75,000 of income are essential to generate a higher level of retained earnings. These earnings are the new capital that is otherwise inaccessible (for example, from equity and bond markets) or very expensive (such as, commercial bank loans). Accordingly, we are pleased that the President's proposal retains graduated rates for corporate taxpayers. This, too, meets the pro-growth and pro-fairness tests.

III. Partial Deductibility of Dividends Paid To Shareholders

Of critical interest to our industry is the President's proposal to allow a partial deduction for dividends paid to shareholders, provided that the corporation has already paid tax at the full corporate rate with respect to the earnings which are paid as dividends. Enactment of a meaningful dividend deduction would be a very important step toward eliminating the economic inefficiencies of the double taxation which is imposed on income from investments in corporations.

A partial dividend deduction, in conjunction with the lower corporate rate, would further reduce the tax law's bias which favors corporate debt over corporate equity. Enhancing the economic viability of equity is a worthwhile long-term objective which should receive substantial attention.

We are disappointed that the President has proposed to restrict the deduction to only 10% of dividends. The Treasury Department's earlier recommendation of a 50% deduction was a much more potent attack on double taxation, particularly in conjunction with a lower corporate tax rate. I urge the Committee to take a hard look at the adequacy of the present proposal. We feel the President's proposal is a step in the right direction and one which hopefully can be expanded at some future date.

## IV. Taxation of Employee Benefits

Retailing is a highly labor-intensive industry whose primary resource is its people. For that reason, we are particularly concerned with the impact of tax reform on employee benefits such as retirement savings and health care.

The proposed treatment of Section 401(k) "cash or deferred arrangements," or "CODAs," is an example. We are pleased that the President, in recognition of the value of CODAs, has rejected the Treasury Department's proposal to discontinue them. However, the proposed changes would significantly undermine these plans, limiting employees' ability to save for their retirement. The proposal reduces the amount an employee may save by imposing a new dollar "cap" on contributions, a new IRA offset, and through new rules which restrict contributions based on the amount contributed by other workers covered by the same plan. These changes are troublesome to older workers who are more interested in saving for retirement (and have more resources to do so), but whose contributions will be limited by the fact that younger workers tend to save less. Workers in the mid-salary ranges ($20,000 to $40,000) are particularly affected. For a company like J. C. Penney, the proposed rules would consider such employees "highly compensated" and would therefore severely restrict their ability to save. In other industries, workers with the same earnings would be able to save considerably more. With minor modifications to the proposed rules which would have minimal revenue impact, equity can be achieved.

Mr. Chairman, the continuing concerns with the costs of Social Security and other government-provided services make the preservation of private retirement and other benefits more important than ever before. We urge that, in reviewing the president's proposal, the Committee carefully consider the wisdom of change which could have unforeseen consequences on private plans and on workers' ability to effectively share in their benefits.

We are also troubled by the Administration's proposal to eliminate the current 10-year averaging provision which allows lump sum distributions from qualified retirement plans to be taxed at more favorable rates. This change strikes us as nothing more than a tax increase on those who can least afford it -- retirees. If there is any concern that the 10-year averaging provision should not be available to those who withdraw accumulated earnings before retirement, this could be addressed by continuing 10-year averaging only for retirement distributions.

Families, working and retired, would also be adversely affected by the proposal to treat as income (for both income and FICA tax purposes) the first $25 of an employer's monthly contribution to health plans. This is a penalty on every wage earner, imposing new taxes on as much as $300 of additional income. This is not justified, in our opinion, as a cost containment measure; it is not consistent with the President's simplification and fairness goals; it also unfairly affects labor-intensive industries like retailing where semi-skilled, lower-paid employees are predominant. We question seriously whether these changes, taken as a group, meet the fairness, growth, and pro-family tests.

## V. Equitable Cost Recovery

In the past, retailing has been particularly disfavored by cost recovery rules because a substantial portion of our total capital equipment -- namely, our buildings -- have been denied the investment credit and have been subjected to long depreciation periods.

In the context of a fundamental restructuring of the income tax, we understand the reasons for a substantial change in cost recovery mechanisms. However, whatever the final depreciation rules are, it is important to retailers that our buildings not continue to be the subject of discrimination.

On this point, there continues to be a widespread perception that anyone who owns or uses a building -- including a retailer -- is part of the overall real estate industry. This is not correct. While a building is critical to the conduct of the retailer's business, the building itself is not the object of that business. Retailing buildings are not inventory items which are bought and sold, or assets which are syndicated and sold to investors, or property which produces rental income for the owner, or assets which are held to generate tax benefits.

The differences between the retailer's use of a building and the uses of buildings by various segments of the real estate industry are very clear. Therefore, retailers do not understand why our buildings continue to be lumped together with the real estate industry for federal tax policy purposes. To address any tax policy issues relating to various sectors of the real estate industry, attention should be given to features of the tax law which affect those sectors alone. In this area, the President's recommendation to extend the at-risk rules to real estate and to deny capital gain treatment to depreciable property are critical.

Additionally, it is critical that the effective date of any new depreciation rules for buildings be based on a contract date, not on the date the building is placed in service. Any transition rule which denies the benefits of the existing ACRS system to buildings not in service by the effective date would be extremely unfair to those who are undertaking new construction, but who are not yet in a position to occupy the buildings.

## VI. Conclusion

In conclusion, Mr. Chairman, I want to reiterate our strong support for the effort which the Committee is undertaking to bring a greater degree of fairness to the income tax laws.

For several decades, new deductions and credits periodically have been added to the tax laws, and existing ones expanded. Each of these actions was made in a good faith effort to provide a measure of relief for certain groups or to encourage taxpayers to take certain actions.

But what has resulted is difficult to justify. The tax laws are now used as a kind of national industrial policy to entice a wide variety of taxpayers into making business decisions because of the favorable tax consequences.

The incentive effects of these deductions and credits have become effective only because they are a means for avoiding high tax rates. But there are now so many of them that the 46% corporate rate is applied to relatively little corporate income, and effective tax rates are widely divergent among various industries.

Now it is time to reduce -- if not eliminate -- the use of the tax laws as an allocator of capital and labor in our economy. We must allow the economic marketplace to serve this purpose by moving toward an income tax which imposes substantially lower rates on a broader base of income. Such a system will reshape the way businesses, investors and consumers alike approach our economic decisions, allowing all of us to direct our resources as markets dictate, making the most of what we invest and spend. Lower rates will yield a higher rate of economic growth and investment, compliance with the law, and prosperity.

Mr. Chairman, the kind of change which the President has proposed should be enacted. Once enacted, let's leave it alone and give it a chance to work.

Thank you.

# CEO'S OF THE RETAIL TAX COMMITTEE OF COMMON INTEREST

Kenneth A. Macke
Chairman of the Board and CEO
THE DAYTON HUDSON CORPORATION

Joseph H. Johnson
Chairman and Chief Executive Officer
ASSOCIATED DRY GOODS CORPORATION

Joseph Berzok
Vice Chairman
BATUS RETAIL DIVISION

David C. Farrell
Chairman of the Board and
Chief Executive Officer
The MAY DEPARTMENT STORES COMPANY

Edward S. Finkelstein
Chairman of the Board & CEO
R. H. MACY & COMPANY, INC.

Howard Goldfeder
Chairman of the Board &
Chief Executive Officer
FEDERATED DEPARTMENT STORES, INC.

Philip M. Hawley
Chairman of the Board &
Chief Executive Officer
CARTER HAWLEY HALE STORES, INC.

William R. Howell
Chairman of the Board &
Chief Executive Officer
J. C. Penney Company, Inc.

Thomas M. Macioce
President & Chief Executive Officer
ALLIED STORES CORPORATION

Peter S. Willmott
President and Chief Executive Officer
CARSON PIRIE SCOTT & COMPANY

American Retail Federation

National Retail Merchants Association

## TAX REFORM HEARINGS - JUNE 13, 1985

## STATEMENT OF J. TYLEE WILSON
## CHAIRMAN AND CHIEF EXECUTIVE OFFICER
## R.J. REYNOLDS INDUSTRIES, INC.
## SENATE FINANCE COMMITTEE
## WASHINGTON, D.C.

Mr. Chairman and Members of the Committee:

My name is J. Tylee Wilson and I am Chairman and CEO of R.J. Reynolds Industries. I submit this statement in support of the President's tax proposals.

R.J. Reynolds is a consumer products company with interests in tobacco, foods and beverages. Our interests include the operations of R.J. Reynolds Tobacco Company, Del Monte, Heublein, and Kentucky Fried Chicken. We market our products worldwide and in 1984 had net sales of nearly $13 billion.

We are, by any measure, a high effective rate U.S. taxpayer. It should not be surprising then that we enthusiastically embrace the basic concept of the President's tax reform proposals because they would greatly enhance our ability to invest more of our resources for the purpose of promoting greater economic growth.

We reviewed the original Treasury Department package and wrote former Secretary Regan in December of 1984, saying in part:

> "Philosophically, we agree with you that governmental allocation of private sector resources through tax code manipulation is unwise."

We have just completed a review of the President's May 1985 tax proposals. Certain modifications in that package will work to our disadvantage over the short term. However, the main thrust of the President's tax reform program remains essentially consistent with that originally proposed by the Department of the Treasury. We say that because the separate themes of lowering the marginal corporate rate from 46 to 33 percent and the effort to work toward a simpler and fairer tax code are consistent objectives in both proposals.

At the outset, I want to make it clear that I support "The President's Tax Proposals for Fairness, Growth, and Simplicity" because I firmly believe that a system of income taxation premised upon the lowest possible tax rate applied against the broadest possible tax base, constitutes an essential prerequisite to our nation's continued and sustainable economic growth. I applaud the President's legislative initiative, and seek your support of its enactment.

I heartily endorse the proposition that our tax system should, to the extent possible, foster economic growth by allowing resources to be allocated on the basis of market forces rather than tax considerations. Such an allocation is required both to promote economic efficiency and to increase fairness, which is so fundamental to meaningful tax reform.

The linchpin of these two essential goals is individual and corporate tax rate reductions. Without rate reductions at least equal to that proposed by the President, we cannot achieve either economic efficiency or fairness, and thus cannot have meaningful tax reform. The President's initiative and commitment, represent an historic opportunity to achieve significant income tax rate reductions. My primary purpose in this statement is to urge that in your deliberations, you start from a premise of equal treatment while placing the burden of proof upon those who seek special subsidies or preferences. Only then will the benefits of tax rate reduction become clear.

Undoubtedly, some representatives of the business community will urge Congress to resist the President's proposals or, in the alternative, seek to minimize their impact on their individual companies and operations. I am confident that such suggestions will be made in good faith, and in some instances, you will hear expressed fears of economic and societal disruptions that may result over the short run. But, as you can well appreciate, Mr. Chairman, your Committee will be grappling with basic and long lasting reforms. We urge that the paramount consideration be the long-range economic collective good that is sought, rather than any short range dislocation that may, or may not, result.

The reforms that have been proposed are not without risk. But the distortions and problems that give rise to the need for tax reform, if allowed to continue, hold far greater risk...the risk of long-term disincentive and economic stagnation.

In my business we take risks every day. Naturally we are prepared to do that and to continue to do so. Sheltering parts of the American economy and insulating it from these marketplace risks has the natural result of overloading those of us who are not protected with an even greater element of risk. Much has been said about "leveling the playing field" and simplicity and fairness in crafting a reformed tax code. Those are worthwhile goals about which few would argue. But we think this opportunity presents for you and the Committee additional challenges of even greater significance. Fairness and simplicity after all are defined differently by each individual. In our judgment, your additional challenge is to unleash the economic power of our great system. Of course, those adversely affected in the short run will likely perceive some of the reforms as unfair. But the test is whether in the long-run the economic viability of our system will be enhanced or weakened. We think, clearly, that the President's proposals pass this test.

As noted earlier, we support the thrust of the

President's package in its entirety. However, there are at least two areas which we believe warrant special attention from the Congress. These are the proposals denying rate reduction benefits attributable to excess depreciation ("windfall recapture"), and the proposals to reform international taxation. We believe the recapture concept should be broadened to reflect the fact that windfall gains can be realized on nondepreciable as well as depreciable investments. In addition, there are numerous provisions of existing law in addition to "excess" depreciation (however defined) that provide timing benefits which, when coupled with rate reduction, produce windfalls. We also believe that the proposals relating to the per-country foreign tax credit limitation and changes in the source rules relating to income derived from the sale abroad of U.S. manufactured goods and the allocation of interest expense, would curtail to some extent investment in U.S. labor and productive facilities in support of international sales and operations. This is particularly unsettling in the face of unparalleled competition for jobs and markets from some of our trading "partners."

In conclusion, then, we support the President's tax package. Specifically, from the perspective of corporate taxation, the rate reduction to 33%, the reduction of double taxation of corporate earnings, and the broadening of the taxable base would provide a system well designed to efficiently raise revenue and provide a framework for further economic growth.

We at R.J. Reynolds are eager to help in anyway that we can to develop lasting and effective tax reform proposals, and will make ourselves available to you and the Committee to advise and assist in this endeavor.

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